Address by C.Rangarajan Governor, Reserve Bank of India at the Silver Jubilee National Convention and Third International Conference of the Institute of Company Secretaries of India Hyderabad

1. The last few years have seen a marked upsurge of interest in the subject of corporate governance. There is widespread feeling that the system of corporate governance is in need of reform although there is no clear consensus on the nature of changes necessary. Corporate governance itself is a term that is not well defined. It may be said to include the policies and procedures adopted by a company in achieving its objectives in relation to its shareholders, employees, customers and suppliers, regulatory authorities and community at large. In a normative sense, it prescribes a code of corporate conduct in relation to all the stakeholders, external and internal. A framework of effective accountability to all stakeholders is the essence of corporate governance. Competition thus needs to be tempered by an appropriate value system so that it works in the long run interest of the companies themselves. In India the question of corporate governance has come up mainly in the wake of economic liberalisation and deregulation of industry and business and the demand for a new corporate ethos and stricter compliance with the law of the land. In the context of the unique situation in India where the financial institutions hold substantial stakes in companies the accountability of the directors including non-executives and nominees has come into sharp focus.

2. The traditional neo-classical theory of the firm makes no distinction between the firm's managers, creditors and owners. The firm is treated as a single homogeneous entity that acts to maximise total value by maximising the discounted value of expected future cash flows. Finance is considered to be just another input in the production process - another factor of production with no effect on the objective function of the firm. If all marketable factors of production are valued in competitive markets the allocative efficiency of the economy would be assured by the maximisation of the residual after payments to those marketable factors. If the claimant of residual is identified with the stockholders who do not gain any benefits other than the residual, they would be unanimously interested in maximising the stock value of enterprises as reflected in the discounted sum of expected future flow of residual. The corporate governance structure in the neo-classical model is thus based on the model of stockholder sovereignty.

3. While increasing shareholder value is considered important, this narrow focus on performance can lead to a number of malpractices, ultimately affecting investors and other creditors. The new paradigm for corporate governance therefore focuses on laying down minimum standards and defining the role of the various players involved in corporate governance. Accountability, it is stressed, is not merely to the investors but also to the creditors, employees, consumers and the community at large.

4. It may be useful in this context to recall the circumstances in which the Committee on financial aspects of corporate governance called the Cadbury Committee was set up and also the other factors which led to an upsurge in the interest in corporate governance in UK. The Committee was set up by the Financial Reporting Council, London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. Its sponsors were concerned at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. These concerns about the working of the corporate system were heightened by some unexpected failures of major companies and by criticisms of the lack of effective board accountability for such matters as directors pay which had risen to excessive levels not related to performance. The

cause of their anxiety was not so much that these companies had failed as that their reports and accounts just prior to their failure, appeared to give no forewarning of the true state of their financial affairs. Its sponsors feared that if no action was taken to improve standards of financial reporting this could affect London's reputation as a financial centre and the reputation of British accounting firms. Later director's pay became such a live political issue that a study group on director's remuneration was formed under Sir Richard Greenbury to deal with directors' pay.

5. The Cadbury Committee addresses a number of specific issues. Considerable attention has been paid to the role of Board of Directors. The report touches on such issues as the composition of the board, separation of the post of the chairman and the chief executive, the role of the outside non-executive directors etc. While recognising the importance of the Boards in driving their companies forward, the report stresses the need for effective accountability. One important section in the Cadbury report relates to financial reporting and financial controls. As the report says "the life blood of markets is information and barriers to the flow of relevant information represents imperfections in the market". The report also adds that "the cardinal principle of financial reporting is that the view presented should be true and fair. Further principles are that boards should aim for the highest level of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to ensure the integrity and consistency of their reports and they should meet the spirit as well as the letter of reporting standards". Transparency through greater flow of information thus becomes important.

6. As the Cadbury Committee Report has repeatedly emphasised, openness, integrity and accountability must be the key elements of corporate governance. In ensuring effective accountability besides the Board of Directors, external auditors and audit committees, the capital markets, institutional investors and banks also have a role to play. Banks have an important role in corporate governance of companies in as much that strong creditors are as critical to the efficient functioning of enterprises as are strong owners. While control by equity holders is appropriate in profitable times, creditor monitoring and control become critical at all times.

7. I would now like to say a few words on corporate governance in banks. With governance becoming an important issue, banking supervisors themselves are concerned with how to improve standards with respect to corporate governance in banks. Governance in banks is determined by the system of processes and controls established internally and externally over its management. It needs to be noted that banking is different from other forms of business in some important respects. Banking has commonly been treated as a matter of public interest given the overall importance of banks to the economy both in regard to its linkages with the real sector and for providing a payments and settlement system. It is for these reasons banks are subject to a higher degree of regulation than other enterprises.

8. The foundation of good institutional governance in banks is a sound business strategy and a competent and responsible management. Good governance in banks also requires comprehensive internal control procedures and policies that are implemented by skilled personnel and monitored by management. Effective risk management by financial institutions is crucial and becomes even more critical as well as complex as markets develop.

9. External auditors play a vital role in the maintenance of overall soundness of the system. Apart from giving an opinion on "true and fair" view of the bank's financial position auditors are also required to verify compliance with regulatory requirements. The responsibilities devolving on auditors have enlarged and it is important that auditors become fully aware of the expectations of the owners of banks and the supervisory authorities.

10. The role of the supervisor in corporate governance encompasses financial regulation including the formulation and enforcement of rules and standards governing financial behaviour as well as the ongoing supervision of individual institutions. Financial regulation and supervision

play an essential role in fostering financial health. They make the financial system strong and resilient. The role of the supervisor is also to ensure that banks implement sound accounting principles, ensure minimum level of disclosure and lay down a comprehensive set of prudential norms and standards. In the absence of such norms and standards the supervisor cannot exercise his powers and responsibilities in a coherent fashion. These norms and standards need to be objective, internally consistent, transparent and well understood by those to whom they are applied. Prudential norms and standards of high quality are also required to assure market participants including stakeholders that sound financial practices are being applied thereby increasing market confidence in the country's overall financial health. It also helps promote a level playing field and fair competition among institutions of a similar type. Supervisors should also enforce strictly these norms and standards. They should have the authority to impose penalties for non-compliance. The penalties could be in the form of fines removal of management in cases of unsafe or unsound banking practices and limiting the activities permitted and in extreme cases closure.

11. In India substantial progress has been made in strengthening the governance of the banks. In the absence of proper governance, weaknesses in the system would get exacerbated. The Board for Financial Supervision was constituted in November 1994 with the specific mandate of exercising prudential supervision over the financial system comprising of commercial banks, financial institutions and financial companies. Since then significant improvement has been brought about under the direction of the BFS in the supervisory framework and governance of banks.

12. The Reserve Bank's role has also been to bring clarity to the roles of the Board of Directors and the external auditors in the governance of banks. Boards have been required to lay down policies in critical areas such as investments, loans, asset-liability management and management and recovery of NPAs. They have to ensure that proper control systems exist and are functioning and that the operations of the bank are conducted with due regard to prudence including the assurance that necessary provisions are made and all statutory and other directives are complied with. The RBI has also directed the banks to set up Audit Committees of the Board chaired by a non-executive director and consisting of non-executive directors. The Audit Committee is charged with the responsibility of ensuring the efficacy of the entire internal control and audit functions in the bank besides compliance with the inspection reports of RBI, internal and concurrent auditors.

13. Banks are required to concurrently audit all departments and branches dealing with treasury functions. Further, 50 per cent of the total business has to be covered by concurrent audit.

14. The role of the external auditors has been enhanced and enlarged. In the auditing of a bank, the auditors' primary duty is to express an opinion on the financial statement such as the balance sheet and the profit and loss account. Besides the audit report on the financial statements, auditors of banks are also required to submit what has come to be known as Long Form Audit Report. It is important that auditors must become fully aware of the expectations of the owners of banks and the supervisory authorities. They are now required to verify compliance with SLR computation on a sample basis and prudential norms and also report serious irregularities to RBI. Further auditors of nationalised banks should certify whether the transactions of bank are within the powers of the bank, and whether the returns received are adequate for the purpose of audit. The RBI has taken a number of measures to improve the transparency and disclosure in the published accounts of banks. From the year 1996-97, banks are required to disclose under "Provisions and Contingencies" in the Profit and Loss Account, details of provision for bad and doubtful debts, provision for diminution in the value of investments, provision for tax separately instead of showing it as a conglomerate item. Banks are also required to disclose the capital adequacy ratio, as well as percentage of net NPA to net advances. The above information will also have to be audited.

15. An important element of the financial sector reform has been introduction of prudential norms and regulations aimed at ensuring the safety and soundness of the financial system, impart greater transparency and accountability in operations and restoring the credibility and confidence in the financial system. The advantage of the norms designed in conformity with international standards are two fold. Those on income recognition and asset classification are meant to discipline the banks as they compel careful assessment of the risks associated with their portfolio and in particular, with respect to the quality of lending. The early recognition of problem loans will also facilitate timely action by banks in addressing problem assets and recovering their dues. Second, they make transparent a bank's financial position relating to quality of assets, levels of earnings and capital position. Banks are required to value their assets objectively for losses - known and potential and the provisioning requirements range from 10 per cent to 100 per cent. Earnings are substantially affected by the quality of assets and it is for this reason that the norms focus on the quality of assets and on upgrading capitalisation. The norms for income recognition and assets classification have been progressively tightened in three successive years to be in conformity with international standards.

16. As far as governance within banks is concerned, the RBI had appointed a Committee to review the internal control and inspection audit function within banks following the rapid changes in the complexion and quantum of bank work in recent years. The Group focussed on imparting uniformity in the system of internal inspection/audit in banks as also follow-up of compliance, quality of concurrent audit, rating of branches etc. The banks have been asked to implement the recommendations. These measures will strengthen the perceived linkage between management and risk control.

17. The RBI supervisory strategy comprises both off-site surveillance and on-site inspections. A detailed off-site surveillance system based on prudential supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality loan concentration, operational results and connected lending has been made operational. In regard to on-site inspection, the focus is now on the evaluation of the total operations and performance of the banks under the CAMELS system i.e. capital adequacy, asset quality, management, earnings, liquidity and internal control systems. Apart from evaluating asset quality and compliance with prudential norms, focus is now on the effective functioning of the Board, management, earning capacity of banks as also efficacy of internal audit and control systems and risk management systems besides regulatory compliance. The new approach to annual financial inspections has been adopted from the cycle of inspections commencing July 1997. An efficient result-oriented on-site inspection system requires an efficient follow-up mechanism; otherwise, the very objective of inspections will be vitiated. The entire cycle of inspection and follow-up action is now completed within a maximum period of twelve months. Monitorable action plan for rectification of irregularities/deficiencies noticed during the inspection within a time frame is drawn up and the progress in implementation pursued with the bank. Thus the present supervisory system makes a substantial improvement over the earlier system in terms of frequency, coverage focus as also the tools employed.

18. A question that has been recently raised world over is whether the regulators should be concerned with the quality of management. It is true that even now supervisors are required to be satisfied that the management is "fit and proper". The wider focus of supervision as envisaged under the CAMELS partly takes care of the problem in this regard. One must however recognise the difficulty in converting qualitative assessment in an area such as this into a quantitative measure.

19. Corporate governance under the new paradigm imposes many responsibilities on professionals. Company Secretaries are an important part of this professional group. Corporate governance goes beyond company law. The company secretary has a key role to play in ensuring that board procedures are both followed and regularly reviewed. The chairman and the board will look to the company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how those responsibilities should be

discharged. The Institute of Company Secretaries has made a valuable contribution in developing a cadre of highly competent professionals and I trust that the company secretary will go beyond ensuring compliance with company law and provide necessary support to the board in maintaining high standards of corporate governance and implementing best practices.