Corporate Governance and Financial Sector: Some Issues

Mr. Bhide, Dr. Saha, Distinguished Chairpersons of banks, FIs, and friends,

The Annual Day of the NIBM has become an important event in the Bank's calendar that all of us look forward to, and I am glad to be with you once again. I am thankful to Mr. Bhide and the Board of the NIBM for giving me this opportunity for an exchange of views on the important subject of Corporate Governance in banks and financial institutions.

This is a timely initiative as the events of last year have made it clear that we in India still have some ground to cover in order to make all our banking institutions safe, sound and efficient. Banks including co-operative banks, NBFCs and FIs, are the custodians of public money, and it is of utmost importance that the public – as depositors, borrowers, and as participants in the economy - has full confidence in the banking system and the sanctity of banking transactions.

This is not possible until each and every institution participating in the financial system has internal management, governance and accountability structures which are upto the best possible standards. This is the reason – the overwhelming public interest – why this subject is so important.

I am also happy to know that, as part of its Annual Day celebrations, NIBM has organised seminars on two other important subjects - interest margins/cost of funds and convergence of business strategies with IT plan. The technical seminars make the Annual Day. – not only an occasion for celebration, but also for an interchange of views on important subjects of common interest among bankers. This is an important initiative and I would like to convey my appreciation to NIBM for organising the seminars at RBI's request.

Needless to say that both these subjects are exceedingly important and have tremendous long term significance for improving the performance of banks, particularly public sector banks. The question of differences in interest spreads in different segments of the banking sector, and the high operational costs of public sector banks in particular was discussed by the Board for Financial Supervision (BFS) of RBI, and NIBM was requested to conduct a study sometime ago. The study has been extensively discussed by banks and further refined in the light of comments. The seminar today will no doubt help in working out an action plan to reduce costs and make the interest rate structure more flexible.

Similarly, the study done by NIBM at the request of RBI on IT is of immense interest. Introduction of computerisation and IT is no longer a matter of choice – unless banks provide easy and fast access to their services, they are bound to lose business. This matter was also discussed by BFS, and followed up with a supplemental comparative study by the RBI on actual productivity and financial gains associated with IT in banks with different levels of computerisation and inter-branch connectivity. The technical sessions this afternoon on this subject, I am sure will be of interest to all the representatives of banks present here.

I am also glad that, in order to participate in the seminars and to give the benefit of his views, Shri Malegam, a member of the BFS and Board of RBI in addition to the RBI Deputy Governors, is also here. We are thankful to him for sparing his valuable time.

I have no special experience on issues relating to Corporate Governance, on which volumes have been written by management and business experts as well as some important committees in several organisations and countries, including OECD, U.K., U.S., and also in India. So with your permission, I would like to just share some random thoughts with you without any rigorous structure. I hope some of the general issues that I mention would be of relevance to your more technical discussions later.

Banks, corporations, financial institutions have been around for a very long time, and an interesting question to ask ourselves is – why this sudden flurry of interest in Corporate Governance? In the last few years, this subject has come to the fore, and a number of committees – the Cadbury Committee, the OECD Code, Combined Code of London Stock Exchange, the Blue Ribbon Committee in U.S, and the Kumara Mangalam Birla Committee in India - why? Why has this subject attracted so much attention in 2002 and not 10 or 20 years ago when all the institutions, banks, and corporations were very much there.

It seems to me that there are some fundamental reasons why Corporate Governance issues have become crucial.

(1) First, liberalisation and deregulation the world over. The regulatory framework and the sophistication of financial markets. In India, for example, earlier either the Government or the RBI will tell you what to do, today there are policies and priorities but considerable deregulation – who to lend, what maturity structure, interest rates, asset management – have to be decided by each bank. Greater freedom implies greater responsibilities. And there are many more players –public sector banks, private banks, co-operatives and NBFCs, etc. Markets are free and more complex.

(2) You may ask – so what? It is upto each corporation or its shareholders – if it does well, they will gain; if they don't, they will lose and so be it. It is their business, why should we collectively worry? Here, banks and financial institutions are in a completely different category. What happens in a particular bank is a concern of all. Fear of contagion and systemic implications. Think of some recent bad cases involving banks, including co-operative banks. Relatively small, but affected a lot of institutions, including some several times larger. In India, because of the dominance of public sector institutions, investors expect more. (Example of LTCM Fund in U.S).

(3) Another factor is that we live in a more volatile and inter- linked world. Effects are instantaneous. If one Letter of Credit fails, it may affect other countries and other institutions. So much greater international attention. Examples of East Asia and Japan. So international institutions are getting involved – in codes and standards, and in assessment of Corporate Governance Structure.

So, for all these reasons, this subject has acquired a completely new dimension and wider interest. And we can no longer avoid it. As you discuss the subject, please keep this in mind.

What is the core of Corporate Governance – for private entities, it may be profit. In the banking sector, it seems that it is risk containment, and early warning systems and prompt corrective action to avoid failure. It is not risk aversion, but risk assessment and providing adequately to cover risks. It is also clear that earlier the detection, the lesser the cost.

Obviously, without a viable and accountable Corporate Governance structure, all this is not possible, however able the CEO. The three essential ingredients of Corporate Governance in this context are:

(a) Checks and Balances: Auditing Committees, External and Internal accounting systems which are independent of decision making on credit and borrowings.

(b) Clear division of responsibility: Both vertical and horizontal, so that responsibility is taken by those who make the decisions.

(c) Disclosure and Transparency: So nothing stays hidden for long, once a decision has been made.

How do we in India fare in Corporate Governance in the financial sector? I am told that there are number of models of Corporate Governance –

(a) the "Outsider" model of the U.S. and U.K. type where there is separation of Ownership and Management; and
(b) the "Insider" model – as in Europe or Asia, where a small group of inter-connected shareholders exercise control over management. East Asian model is more family oriented while European model involves inter-connected entities. In the "insider" model, it is difficult to distinguish between shareholder and management respectively.

In India, in the financial sector, we now have all the three varieties with certain important differences with the U.S., Europe or Asia. Public sector banks/FIs, for example, are more akin to the 'outsider' model with separation of "Ownership' and 'Management'. Private sector banks/NBFC/Co-ops – much more "insider" models with families, inter-connected entities or promoters running the management. There is some uniformity in the Corporate Governance structure in the "outsider model" consists of relatively large public institutions, and which are also relatively old.

<u>On the positive side:</u>

(a) difference in ‘Ownership’ and ‘Management’;

(b) Disclosure and transparency(with one or two exceptions). They are also becoming subject to better accounting standards;

(c) Prudential norms – Capital Adequacy Ratio (CAR), provisioning, rec. norms are fairly good. Because of sovereign risk, money is also safe with one - two aberrations.

<u>On the negative side:</u>

(a) there is separation of ‘Ownership’ and ‘Management’, but no checks and balances. CEO as well as the Board is appointed by the owner, i.e Government

(b) Very little accountability to the Board as Board cannot remove the Chairman;

(c) Substantial limitations on management as staff issues are outside the purview of management;

(d) Weak on internal auditing and risk management.

The crucial issue that the country has to debate is whether Corporate Governance is compatible with public ownership, which makes the system accountable to political institutions and not to the economic institutions or even regulators. This is a big and fundamental issue which our country has to debate and decide. Is a “via media” possible? Could we have public ownership without Government or political control or do we need to change to a corporate structure? Is it possible to make the Boards responsible for appointment of CEOs, and make the Board appointments less discretionary on the part of the Government in power?

I don’t want to express a view, but these are real issues. As the resolution of these issues will take considerable time, our task is to see what can be done within the present public sector structure.

Something can be done – better internal checks and balances, better auditing, better transparency, better enforcement of policies, better action over NPAs, timely action against frauds. I hope you will give consideration to these in the interim, while we debate the larger issues.

As regards the “insider” model, there is a tremendous variation both in terms of risk as well as Corporate Governance structure. By and large, the structure is very weak in Co-operatives and NBFCs for historical reasons, local practices, and multiplicity of regulators and laws. Old private banks also have very poor auditing and accounting systems. New private banks – generally good on accounting, but poor on accountability. More modern and computerised, but less risk conscious, One thing which is common to all is that Corporate Governance is highly centralised with very little real check on the CEO, who is generally also closely linked to the largest owner groups. Boards or auditing systems are not very effective.

So, in all the segments, and all different sizes of institutions, we have a great deal of work to do in the area of Corporate Governance. RBI has been working on new accounting, auditing and disclosure standards. Work is also in progress in setting better internal auditing and better system of checks and balances. A Committee of Ind. Dir. has also been set up under Dr. Ganguly, Member of the BFS to learn from the past experience. RBI and other regulators would do their best to bring about better standards, but ultimately it is upto the individual institutions, and the people managing them to ensure what actually happens on the ground.

Let me conclude. Corporate Governance has never been more imp than now. It is not only the business of an individual bank or entity, but of all of us. 5 or 10 years down the line, you would not be able to operate unless we have Corporate Governance of the best standards. In many areas, we have made progress in laying down what needs to be done. The important task now is to put appropriate mechanisms in place to enforce accountability, asset liability management, early warning and prompt corrective action systems. With your help, and the leadership shown by NIBM, I am sure we will get there.

In the end, let me congratulate Mr. Bhide and Dr.Saha once again. As you know, following Tarapore Committee, RBI has introduced important changes in the management structure of NIBM. NIBM has made substantial progress in the last couple of years I have no doubt that with the help of all of you, NIBM would become a truly national institution of distinction for improving the management and Corporate Governance in banks and financial institutions.

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* Excerpts of the Speech delivered by Dr. Bimal Jalan, Governor, Reserve Bank of India, at the National Institute for Bank Management, Pune, on January 6, 2002