Corporate Governance: Towards Best Practices*

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Corporate governance is increasingly demanding our attention and has moved centrestage. The Enron and WorldCom scandals in the U.S have amply demonstrated the necessity of having a system of corporate governance even in the developed world. In a liberalising and deregulating country like India, corporate governance is all the more important. In this context, it is indeed heartening to note that Bankers' conference is devoting a full session on "corporate governance". In this address let me touch upon the basic cornerstones of corporate governance in Indian banking sector.

The Basic Issue

Modern day corporations are known for the separation of ownership and control. After all, the managers are merely paid employees and the agency theory taught us that the independent managers can operate in a way that could be *detrimental* to the interests of the shareholder. It is, thus necessary, to have a mechanism by which the shareholders' interest are protected by the managers. It is here that corporate governance can play a crucial role. What is corporate governance then? I can do no better than to quote from Professors Shleifer and Vishney, who defined corporate governance as dealing with "the ways that suppliers of finance to corporations assure themselves of getting a return on their investment".[1]

Corporate governance is however conceptually different for banks. The business model of financial intermediaries especially of banks envisages dealing in the financial resources of others and most of their liabilities constitute debt which are in the form of deposits. Since depositors are the main suppliers of finance to a bank, their interest is paramount and therefore directors and officers of a bank should be charged with a heightened duty to ensure the safety and soundness of these enterprises. Banks are highly leveraged organisations, they undertake maturity transformation and hence create maturity mismatches between their assets and liabilities and rely on the confidence of their creditors. There is also the contagion impact and the issue of maintaining the integrity of the payments system in which banks play a significant role. Corporate governance therefore affects the interests of a larger cross-section of stakeholders also has implications for financial stability and is one of the key factors that determines the health of the system and its ability to survive economic shocks.

Corporate governance practices differ widely across the world. In a highly dispersed shareholding system normally it is the board of directors who are granted the responsibility of monitoring executives (*e.g*., U.S). On the other hand, allowing for concentrated and cross shareholding, countries like Germany or Japan adopted 'internal' corporate governance systems. Corporate governance for an emerging market economy (EME) has an added dimension. After all, since the late 1980s / early 1990s, the financial sector of a number of EMEs has seen a wave of liberalisation and deregulation. Greater deregulation in markets and in banks operations requires better governance as more responsibility rests with the Board and the management.

It is because banks are a critical component of the economy that it is universally a regulated industry and banks have access to safety nets. It would, however, be erroneous to conclude that regulatory oversight is a substitute to corporate governance. There exists complementarity between *regulation* and *corporate governance* in banking. Perhaps it is in this spirit that the Bank for International Settlement (BIS) in discussing enhancing corporate governance for banking organisation observed that, "banking supervision cannot function as well if sound corporate governance is not in place and consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance in every banking organisation".

∗ Address by Smt Shyamala Gopinath, Deputy Governor, Reserve Bank of India at the Bankers' Conference on November 10, 2004 at New Delhi.

[1] Shleifer, A and R. Vishney (1997): "A Survey of Corporate Governance", *Journal of Finance*, Vol.52.

Global Best Practices

A number of supranational organisations have drawn codes/principles of corporate governance. The most well known is perhaps the OECD principles of corporate governance of 1999. It is instructive to summarise the five basic pillars of OECD code, *viz*.,

(i) Protecting the rights of shareholders;

(ii) Ensuring equitable treatment of all shareholders including having an effective grievance redressal system;

(iii) Recognising the rights of stakeholders as established by law;

(iv) Ensuring the timely and accurate disclosure regarding the corporation including the financial situation, performance, ownership and governance of the company; and

(v) Ensuring the strategic guidance of the company, effective monitoring arrangement by the board and the board's responsibility to the company and the shareholder.

While the OECD principles went a long way in emphasising the basic tenets of corporate governance, it is the 1999 BIS paper that went specifically to the issue of enhancing corporate governance for banking organisation. From banking industry perspective, BIS proposed the following seven principles:

i) Establishing strategic objectives;

ii) Setting and enforcing clear lines of responsibility and accountability;

iii) Ensuring that the board members are qualified for their position and are not subject to undue influence from the management or outside concerns;

iv) Ensuring that there is appropriate oversight by senior management;

v) Effectively utilising the work conducted by internal and external auditors;

vi) Ensuring that compensation approaches are consistent with the bank's ethical values; and

vii) Conducting corporate governance in a transparent manner.

Again, from a banking sector perspective, the BIS principles noted categorically two specific things, *viz.*, (a) the role of supervisors, and (b) the paramount interest of depositors.

Apart from such supranational organisations or regional organisation like EU, all the G-7 countries as well as other developed economies have codified some kind of 'best practices' on corporate governance, or some specific aspects of it. While a comprehensive survey of the country-specific principles of corporate governance is beyond the scope of the present address, one is tempted to cite the recently enacted Sarbenes-Oxley Act of 2002 in US, aiming to protect investors by improving the accuracy and reliability of corporate disclosures.

It is against this background of global best practices let me now turn to the Indian experience on corporate governance.

Corporate Governance and Indian Banks

The initial formal moves towards corporate governance in India can be traced in 1997 with the voluntary code framed by the Confederation of Indian Industry (CII). A number of companies over the next three years (nearly 30 large listed companies accounting for over 25 per cent of India's market capitalisation) voluntarily adopted the CII code.[2] The next major cornerstone in the Indian case has been the SEBI Committee chaired by Shri Kumar Mangalam Birla (1999), as the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies and the state of capital markets. The Committee recommended that the fundamental objective of corporate governance is the "enhancement of shareholder value**,** keeping in view the interests of other stakeholder". The Committee made recommendations of far-reaching implications for several issues, such as, the independence of board, accounting standards and financial reporting, share-holders' rights and responsibilities, and formation of audit and remuneration committee.

The initial move towards corporate governance in banks can be traced in the Advisory Group on Corporate Governance for the RBI Standing Committee on International Financial Standards and Codes, chaired by Dr. R.H. Patil, which submitted its Report in 2001. The

[2] Omkar Goswami (2001): "The Tide Rises: Corporate Governance in India", *OECD Development Centre Discussion Paper*.

Advisory Group has noted that the predominant form of corporate governance in India is much closer to the East Asian 'insider' model where the promoters dominate governance in every possible way. Among the various recommendations, strengthening of the Companies Act and the role of Independent Directors deserve special mention. The Group looked into public sectors banks and noted that the first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. Furthermore, as a part of strengthening the functioning of their boards, banks should appoint a risk management committee of the board in addition to the three other board committees *viz.*, audit, remuneration and appointment committees.

The Advisory Group on Banking Supervision for the Standing Committee on International Financial Standards and Codes, while looking into several areas in which internationally accepted best practices are already in place, probed into corporate governance as well. The noteworthy minimum benchmarks noted by the Group relate to the following:

(i) strategies and techniques basic to sound corporate governance;

(ii) organisational structure to ensure oversight by board of directors and individuals not involved in day-to-day running of business;

(iii) ensuring that the direct line of supervision of different business areas are different;

(iv) ensuring independent risk management and audit functions;

(v) ensuring an environment supportive of sound corporate governance; and

(vi) role of supervisors.

Interestingly, with reference to public sector banks, the Group noted that the nature of a bank's ownership is not a critical factor in establishing sound corporate governance practices and concluded that, "the quality of corporate governance should be the same in all types of banking organisations irrespective of the nature of their ownership". The Group, however, felt that there are some areas where practices in the Indian banking sector fell short of international best practices, *viz.*, a) constitutions of boards, b) their accountability, and c) their involvement in risk management. The Group gave special emphasis on enhanced transparency in the constitution and structure of the board and senior management and in public disclosures.

Taking this move towards corporate governance further, the Reserve Bank constituted a Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A.S. Ganguly) to review the supervisory role of Boards of banks and FIs. The Ganguly Consultative Group looked into the functioning of the Boards *vis-à-vis* compliance, transparency, disclosures, audit committees and suggested measures for making the role of the Board of Directors more effective. The Group submitted its recommendations in April 2002. The major recommendations of the Group are the following:

i) Government while nominating directors on the Boards of PSBs should be guided by certain broad "fit and proper" norms for the Directors, based on the lines of those suggested by BIS.

ii) The appointment / nomination of independent / non-executive directors to the Board of banks (both public sector and private sector) should be from a pool of professional and talented people to be prepared and maintained by RBI.

iii) It would be desirable to take an undertaking from every director to the effect that they have gone through the guidelines defining the role and responsibilities of directors, and understood what is expected of them.

iv) In order to ensure strategic focus it would be desirable to separate the office of Chairman and Managing Director in respect of large-sized PSBs.

v) The information furnished to the Board should be wholesome, complete and adequate to take meaningful decisions. The Board's focus should be devoted more on strategy issues, risk profile, internal control systems, overall performance, *etc.*

vi) It would be desirable if the exposures of a bank to stockbrokers and market-makers as a group, as also exposures to other sensitive sectors, *viz.*, real estate *etc.* are reported to the Board regularly.

vii) The disclosures of progress made towards establishing progressive risk management system, the risk management policy, strategy, exposures to related entities, the asset classification of such lending / investments *etc.* should be in conformity with corporate governance standards, *etc.*

viii) Finally, the banks could be asked to come up with a strategy and plan for implementation of the governance standards recommended and submit progress of implementation.

The Ganguly Committee recommendations have been benchmarked with international best practices as enunciated in the Basel Paper as well as of other Committees and advisory bodies to the extent applicable to the Indian environment. RBI has also implemented most of the recommendations. In general these regulations have created an enabling framework for improving corporate governance in financial institutions.

Subsequently, the circular issued on June 25, 2004 on 'fit and proper' criteria for directors of banks enumerated a number of principles; the following among them deserve special mention, *viz.*,

i) undertaking a process of due diligence on the part of the banks in private sector to determine the suitability of the person for appointment / continuing to hold appointment as a director on the Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria;

ii) the process of due diligence should be undertaken by the banks in private sector at the time of appointment / renewal of appointment;

iii) the boards of the banks in private sector should constitute Nomination Committees to scrutinise the declarations;

iv) banks should obtain annually, as on March 31, a simple declaration that the information already provided has not undergone change and where there is any change, requisite details are furnished by the directors forthwith.

These principles, I believe would go a long way to ensure corporate governance in banks in India.

Some Emerging Issues

I have, in the present address, tried to give a flavour of the various attempts towards ensuring and improving corporate governance in India and noted that the path has been one of progressive disclosures and increasing convergence to international standards. Nevertheless, the task is far from over, and, therefore in conclusion, let me raise some of the emerging issues for further consideration and deliberation at this august gathering.

Financial distress episodes in a number of countries were caused in part by excessive exposure concentration, lending to connected parties, poor credit policy and inadequate management of risk mainly foreign exchange risk. To a large extent, such basic risk management failures reflects a failure of corporate governance. Besides laying down prudential guidelines, RBI has been emphasising the need for better understanding and oversight at the Board level of key banking risks. Boards of the banks will have to take solvency and other risk systematically into account while making decisions. The Basel II proposals too underscore the interaction between sound risk management and corporate governance. For example, the IRB approach to credit risk sets out requirements for sound risk assessment processes, robust controls and transparency. In turn, the board and senior management are expected to understand and guide a bank's overall risk management and performance. Supervisors are required to ensure that all banks institute good governance practices irrespective of the capital approach adopted.

Second, issue relates to Board strategies to ensure strong internal control systems including internal and external audit functions and other checks and balances. Independent audit committees can help in translating audit reports into meaningful action, both corrective and preventive.

Third, further steps to be taken to improve transparency through more disclosures of information related to corporate governance. It is worthwhile examining the efforts of some companies to pivot their annual reports on corporate governance issues while making appropriate disclosures on each.

Fourth, increasingly concerns are raised about the conflict of interest in financial sector. Four areas of the financial service industry have a high potential for conflicts of interest: underwriting and research in investment banking, auditing and consulting in accounting firms, credit assessment and consulting in rating agencies and universal banking. A combination of market discipline supplemented by mandatory disclosure of conflicts and supervisory oversight are generally considered necessary to contain the exploitation of conflicts of interest. These measures are intended to have positive impact on investor confidence, efficacy of the regulatory framework and, above all, the credibility of those associated with the financial services. Accordingly, in consultation with Chairman, SEBI and

Chairman, IRDA, in the Mid-Term Review of Monetary and Credit Policy for 2003-04, it has been proposed to constitute a Working Group on avoidance of conflicts of interest. The Working Group will identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms in India in this regard and make recommendations for avoidance of such conflicts of interest.

Fifth, there is a need for a strong culture of compliance at the top of the organisation and it will be necessary to consider how management can respond appropriately to ethical or reputational concerns that come to their knowledge.

Sixth, there is perhaps a need for consultative process to harmonise the approaches suggested by the Ganguly Committee of RBI and the Narayana Murthy Committee of SEBI. In the recently announced Mid-Term Review of Annual Policy for 2004-05, it was proposed to harmonise these approaches suggested by the Ganguly Committee and the SEBI Committee in regard to banks through a consultative process. It will be useful to know the areas for further harmonisation.

Lastly, corporate governance does not end with commercial banks. It is imperative to extend the above principles of good corporate governance practices to cooperatives, PDs, NBFCs and other financial institutions.