Corporate Governance in the Financial Sector

I am happy to be here today at the annual seminar of insurance regulators and feel fortunate to share the platform with a very distinguished international expert Dr. YRK Reddy of the Academy of Corporate Governance.

Keeping in view the discussions on corporate governance scheduled at the seminar I intend to give a brief overview of the role and importance of corporate governance in the banking sector, initiatives undertaken by RBI and then a flag a few generic issues relating to corporate governance based on our experience with the banking sector. Though the 'deposit accepting' feature of banks sets them apart from other financial intermediaries, the basic elements of governance in any public institution can be said to be sector independent. Moreover although objectives of banking sector regulators may be slightly different from those of insurance regulators there are a number of commonalities and in some countries banking and insurance regulation is in one institution. I therefore, hope that this interaction would be found useful by the participants.

Corporate Governance and banks

Although globalisation of financial markets necessitates some basic international standards of corporate governance for financial institutions, it is also recognized that such uniform international standards may result in different levels of systemic risk for different jurisdictions because of differences in business customs and practices and institutional and legal structures of national markets. Each country will therefore need domestic regulations that prescribe specific rules and procedures for the governance of financial institutions that address national differences in political economic and legal systems while adopting international standards and principles.

Banks are “special” as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. The role of banks is integral to any economy. They provide financing for commercial enterprises access to payment systems and a variety of retail financial services for the economy at large. The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing in many cases a government safety net to compensate depositors when banks fail. The large number of stakeholders whose economic well being depends on the health of the banking system depend on implementation of appropriate regulatory practices and supervision. Indeed in a healthy banking system the regulators and supervisors themselves are stakeholders acting on behalf of society at large. As regulators we do not act on behalf of shareholders or individual customers but on behalf of groups such as depositors policyholders or pension fund members who rely on the continued solvency of regulated institutions for their financial security but who are themselves not well placed to assess financial soundness.

Banks unlike insurance companies are highly leveraged entities and asset liability mismatches are an inherent feature of their business. Consequently, they face a wide range of risks in their day-to-day operations. Any mismanagement of risks by these entities can have very serious and drastic consequences on a stand alone basis which might pose a serious threat for financial stability. This dimension further strengthens our premise that effective risk management systems are essential for financial institutions and emphasises the need for these to be managed with great responsibility and maturity. Good corporate governance, therefore, is fundamental to achieve this objective.

Governance – Principal Agent problem

The main characteristics of any governance problem are that the opportunity exists for some managers to improve their economic payoffs by engaging in

unobserved socially costly behaviour or abuse and the inferior information set of the outside monitors relative to the firm. There is a wide range of potential agency problems in financial institutions involving several major stakeholder groups including but not limited to depositors owners creditors management and supervisory bodies. Agency problems arise because responsibility for decision making is directly or indirectly delegated from one stakeholder group to another in situations where objectives between different stakeholder groups differ and where complete information which would allow for further control to be exerted over the decision maker is not readily available. Primarily there are three groups which can monitor the management of banks: owner, market and supervisors.

The oversight by the Board is an important part of governance in banks. In addition oversight by non-executives who are not involved in day to day management is also important, direct line supervision in different areas and independent risk management and audit functions also form part of the organizational structure of any bank which ensures proper governance.

Initiatives taken by RBI

The importance attached to corporate governance in banks is reflected in the fact that the Reserve Bank had constituted at least three committees/ working groups to assess and make appropriate recommendations. These are:

- A Standing Committee on International Financial Standards and Codes was constituted to, inter alia, assess the status in India vis-à-vis the best global practices in regard to standards and codes. An Advisory Group on Corporate Governance (Chairman: Dr. R. H. Patil) made detailed assessment and gave recommendations of which those relating to PSBs is an important component.
- The Advisory Group on Banking Supervision (Chairman : Mr. M.S. Verma) has also made some recommendations on corporate governance.

- A Consultative Group of Directors of banks and financial institutions (Chairman Dr. A.S. Ganguly) was constituted to review the supervisory role of Boards of banks and financial institutions and to obtain feedback on the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees etc. and make recommendations for making the role of Board of Directors more effective.

The Groups made their recommendations after a comprehensive review of the existing framework as well as of current practices and benchmarked the recommendations with international best practices as enunciated by the Basel Committee on Banking Supervision, as well as of other committees and advisory bodies, to the extent applicable in the Indian environment. The Groups made far reaching proposals to improve corporate governance and many, if not all, do require legislative processes and they are necessarily time consuming and often realizable only in medium-term. While proceeding with analysis and possible legislative actions, changes that could be brought about within the existing legislative framework have been implemented.

The issue of corporate governance in banks, like any organization, needs to be addressed in regard to (i) quality and concentration of ownership; (ii) quality of Management (iii) prudential framework and (ii) the mechanism for effective oversight of Board of Directors.

I. Quality and concentration of ownership

The ownership issue in banks straddles a few crucial issues that have been engaging our attention and a policy environment is being sought to be created that would confirm to the best principles of governance. Unique corporate governance challenges are posed where the ownership structure lacks transparency or where there insufficient checks and balances on inappropriate influences of controlling shareholders. While there can be different views on the

issue of concentrated ownership there is clearly a recognition that significant shareholders should pass the fitness and propriety tests.

The current legal and policy framework with respect to ownership in banks, at a sectoral level, entails the following :

(i) Voting rights restriction as per banking laws

In terms of the statutory provisions under the various banking acts, the voting rights, when exercised, have been stipulated as under:

Private Sector Banks – [Section 12(2) of Banking Regulation Act,1949]	No person holding shares, in respect of any share held by him, shall exercise voting rights on poll in excess of ten percent of the total voting rights of all the shareholders.
Nationalised Banks – [Section 3(2E) of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80]	No shareholder, other than the Central Government, shall be entitled to exercise voting rights in respect of any shares held by him in excess of one percent of the total voting rights of all the shareholders of the nationalised bank.
State Bank of India (SBI) - (Section 11 of State Bank of India Act,1955)	No shareholder, other than RBI, shall be entitled to exercise voting rights in excess of ten percent of the issued capital, (Government, in consultation with RBI can raise the above voting right to more than ten percent).
SBI Associates - [Section 19(1) and (2) of SBI (Subsidiary Bank) Act, 1959]	No person shall be registered as a shareholder in respect of any shares held by him in excess of two hundred shares. No shareholder, other than SBI, shall be entitled

	to exercise voting rights in excess of one percent of the issued capital of the subsidiary bank concerned.

(ii) Acknowledgement of RBI for transfer of shares more than 5%

In respect of private sector banks, RBI had issued guidelines in September 1999, revised in February 2004, on the grant of acknowledgement for acquisition and transfer of shares. In terms of these, acknowledgement from RBI for acquisition/transfer of shares is required for all cases of acquisition of shares which will take the aggregate holding (direct and indirect, beneficial or otherwise) of an individual or group to equivalent of 5 percent or more of the paid-up capital of the bank. For higher thresholds, 10% and 30%, increasingly stricter criteria would be adopted for considering granting of acknowledgements.

(iii) Restrictions on cross holdings: a bank's aggregate investment in the following instruments issued by other banks and financial institutions is permitted up to 10 per cent of the investing bank's capital funds (Tier I plus Tier II capital

a. Equity shares;
b. Preference shares eligible for capital status;
c. Subordinated debt instruments;
d. Hybrid debt capital instruments; and
e. Any other instrument approved as in the nature of capital.

Further, banks' / FIs' investments in the equity capital of subsidiaries are at present deducted from their Tier I capital for capital adequacy purposes.

II. Board of Directors

The framework in respect of ensuring effective oversight by the Board of Directors incorporates the following:

(i) Statutory requirement regarding composition of Board of Directors

(ii) BOD establishes strategic objectives and a set of corporate values that are communicated throughout the banking organisation.

(iii) BOD have an obligation to understand the risk profile of the institution and ensure adequate capital to cover the risk

(iv) Unique challenge when the institutions have complex corporate structures. Where a bank is part of a wider group either as parent or subsidiary a number of of issues arise from the corporate governance perspective in that it is likely to affect to a certain extent structure and activities of both parent and subsidiary boards. Need for effective control of subsidiaries by the parent board.

(v) Excessive outsourcing of intragroup activities also causes concerns from the supervisors point of view.

(vi) Group dimension also creates conflict of interest within the Group which have to be managed.

(vii) Guidelines regarding criteria for appointment of directors, role and responsibilities of directors and the Board

(viii) Covenants & undertaking: A declaration and undertaking is required to be obtained from the proposed / existing directors. The directors are required to execute a covenant binding them to discharge their responsibilities to the best of their abilities, individually and collectively. Further, the issue related to the broader issue of fit and proper status of directors and signing of the covenants should be one of the criteria to be eligible to be a director of a bank. The board of the bank must ensure in public interest that the nominated / elected directors execute the deeds of covenants as recommended by Dr. Ganguly Group.

(ix) Training / Seminars: The banks have been advised to ensure that the directors are exposed to the latest managerial techniques, technological developments in banks, and financial markets, risk management systems etc. so as to discharge their duties to the best of their abilities.

While RBI can offer certain training programmes/seminars in this regard at its training establishments, large banks may conduct such programmes in their own training centres.

(x) Audit committee of the Board In 1995, the RBI directed banks to set up Audit Committees of their Boards, with the responsibility of ensuring efficacy of the internal control and audit functions in the bank besides compliance with the inspection report of the RBI, internal and concurrent auditors. To ensure both professionalism and independence, the Chartered Accountant Directors on the boards of banks are mandatory members, but the Chairman would not be part of the Audit Committee. Apart from the above, Board level committees that are required to be set up are Risk Management committee, Asset Liability Management committee (ALCO), etc. The Boards have also been given the freedom to constitute any other committees, to render advice to it.

(xi) Sound practices for CR, MR and OR management emphasizing role of Board & Senior management: As the primary responsibility of laying down risk parameters and establishing an integrated risk management and control system rests with the Board of Directors, the banks were advised that all assessments of the risk management systems should be placed before the Board. On the basis of such evaluation banks should initiate appropriate steps, with the approval of their Board, to eliminate the gaps in compliance with the risk management guidelines issued by RBI and ensure that they have efficient and robust risk management systems in place.

(xii) ‘Fit and proper’ assessment in respect of all persons to be appointed on the Boards of private sector banks,

(xiii) The earlier practice of RBI nominating directors on the Boards of all private sector banks has yielded place to such nomination in select private sector banks.

III. Quality of management

1. Senior management consists of a core group of individuals responsible for the day to day management of the bank –should have necessary skills and oversee line managers in specific business areas and activities consist with policies and procedures laid down by the Board.
2. Senior Management establishes effective system of internal controls
3. Fit and proper norms for CEO and directors were laid down in terms of circular dated June 25, 2004. It was mandated that 'On appointment of Directors, due diligence of the directors of all banks – be they in public or private sector, should be done in regard to their suitability for the post by way of qualifications and technical expertise. Involvement of Nomination Committee of the Board in such an exercise should be seriously considered as a formal process.'
4. Prior approval of Reserve Bank of India for appointment of CEO as well as terms and conditions thereof.
5. Powers for removal of managerial personnel, CEO and directors, etc. in the interest of depositors.

IV Prudential standards

The whole principle of capital regulation is that the owners will monitor if they have much at stake either in the form of capital or future profits. Hence the emphasis on capital adequacy. Similarly the need for prudential norms on income recognition and asset classification and provisioning is required because of the nature of bank balance sheets-loan assets do not lend themselves to proper valuation. Appropriate accounting standards, connected and related party transaction regulations, risk based supervision enforcement of corporate governance rules are essential for promoting sound corporate governance. In fact the importance of corporate governance permeates the Core Principles for banking Supervision against which we assess our practices.

Other monitors include PCA framework or structured early intervention approach. However, regulation cannot be a substitute for corporate governance.

Transparency as a tool to promote corporate governance

To accurately evaluate a bank's disclosures about its financial position and financial performance and its risks and risk management strategies, market participants and supervisors need fundamental information about the bank's business, management and corporate governance. Such information can help provide the appropriate perspective and context to understand a bank's activities and help in the effective operation of market discipline which would indirectly address any weaknesses in corporate governance and also encourage enhanced role of corporate governance on the level and quality of disclosures. Thus transparency and good corporate governance can be seen as complementary issues – like two sides of the same coin. Certain disclosures mandated from corporate governance angle are:

- **Related party transactions**: The banks are required to disclose the name and nature of related party relationship, irrespective of whether there have been transactions, where control exists within the meaning of AS 18. Related parties for a bank are its parent, subsidiary(ies), associates/ joint ventures, Key Management Personnel (KMP) and relatives of KMP. KMP are the whole time directors for an Indian bank and the chief executive officer for a foreign bank having branches in India. Relatives of KMP would be on the lines indicated in Section 45 S of the R.B.I. Act, 1934.
- **Segment reporting**: For reporting of business information under geographical and business segments in terms of AS 17, banks are required to disclose their 'domestic' and 'international' operations as geographical and 'Treasury', 'Other banking operations' and 'Residual operations' as business segments.
- RBI also puts in public domain details of the levy of penalty on a bank for contraventions of any of the provisions of the Act or non-compliance with

any other requirements of the Banking Regulation Act, 1949; order, rule or condition specified by Reserve Bank under the Act.

- While there is no accounting standard in India for disclosure of derivatives business by incorporated entities, RBI has prescribed a minimum framework for **disclosures by banks on their risk exposures in derivatives**. The disclosure format includes both qualitative and quantitative aspects and has been devised to provide a clear picture of the exposure to risks in derivatives, risk management systems, objectives and policies. It broadly included the notional as well as mark to market value of outstanding derivative contracts along with the credit equivalents for the same. The banks are also required discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion is expected to include:
    - the structure and organization for management of risk in derivatives trading,
    - the scope and nature of risk measurement , risk reporting and risk monitoring systems,
    - policies for hedging and / or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges / mitigants, and
    - accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.
- Apart from the above, in case of listed banks there is added ‘market oversight’ which subjects them to additional post-listing disclosures.

Does compliance with accounting and auditing standards promote better corporate governance?

The role of sound accounting and adequate disclosure in the creation of useful information for markets and investors is obvious. Sound auditing standards applied properly by auditors who also maintain high standards of professional conduct also contribute to market and investor confidence. In turn, these disciplines are also responsive to the changing needs of market, investors and other external stakeholders. Compliance with accounting standards also contributes to transparency with regard to certain aspects which are relevant to corporate governance.

Role of rating agencies in CG: The role of rating agencies in influencing corporate governance has started being appreciated. By providing independent analyses of the strengths and weaknesses of banks, rating agencies play a critical role in the capital market. To managements and boards, their comments can be early warning signals which can impel bank strengthening measures. Going forward, rating agencies should focus more on governance risks and develop a methodology that explicitly assesses the quality of governance.