

## *Governance in Banks and Financial Institutions\**

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Shri Deosthalee and senior management of L & T. A very good evening, I deem it a privilege to address you this evening on 'Governance in banks and financial institutions'.

2. Governance issues have been engaging the attention of policy makers, more intensely in the aftermath of the global financial crisis. Many instances of governance failures have come to the fore as the contributory factors that had exacerbated the crisis. With lessons learnt from the crisis, the framework is being revisited so as to strengthen the governance standards.

### **What is Governance?**

3. What exactly is Governance? Governance, in general terms, means the process of decision making and the process by which decisions are implemented (or not implemented)<sup>1</sup>, involving multiple actors. Good governance is one which is accountable, transparent, responsive, equitable and inclusive, effective and efficient, participatory and which is consensus oriented and which follows the rule of law.

4. The 1992 Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) describes corporate governance as the system by which companies are directed and controlled. As per Organisation for Economic Cooperation and Development (OECD), Corporate Governance involves<sup>2</sup> 'a set of relationships between a company's

management, its board, its shareholders and other stake holders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.'

5. The whole gamut of corporate governance could be considered as a blend of various segments<sup>3</sup> namely, regulatory governance, market governance, stake holder governance and internal governance. For an economy to perform well and for the financial system to be stable, good corporate governance would be required across all these segments. Regulatory governance refers to control exercised by regulators over firms through statutes, policies and regulations. Market governance denotes the use of market-based controls which discipline the corporate behaviour. While stakeholder governance alludes to the direct or indirect control by various stakeholder groups having direct or indirect interest in the corporations, internal governance refers to the institutional arrangement of checks and balances within the corporation.

### **Why is corporate governance important for financial institutions?**

6. While good governance is essential for any entity, it has deeper significance for financial institutions. There are many compelling reasons, some of which are:

- a. Financial institutions are central to economic activity – banks and a large part of the non-

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<sup>1</sup> United Nations Economic and Social Commission for Asia and the Pacific, 'What is good governance'.

<sup>2</sup> OECD Principles of Corporate Governance(2004).

<sup>3</sup> Sun, William, Stewart, Jim and Pollard, David; 'A systemic failure of corporate governance: Lessons from the on-going financial crisis'.

banking financial system (the shadow banking system) undertake credit intermediation. Failures of financial institutions would thus impede the economic growth and would cause serious damage to the system. Economies take longer time to rebound from financial crisis than the business cycle recessions.

- b. Financial institutions operate on a higher leverage. As per a study by the Bank for International Settlement (BIS) for the period 1995-2009, compared to non-financial institutions that had a leverage of about 3, banks operated at a leverage of 18.3 while non-bank financial firms had a leverage of 12.1. Higher leverage makes financial intermediaries more vulnerable to shocks. From a systemic perspective, the inherent procyclicality of the financial system leads to the build up of high leverage during upturn phase of the economy which amplifies booms and busts. Therefore, while the procyclicality issues need to be dealt with from a financial stability perspective, it is apparent that these financial institutions must be well governed for achieving financial stability.
- c. Financial institutions, especially banks, deal in people's savings and trust of customers forms the cornerstone of their existence. Any breach of trust leading to loss of confidence is bound to lead to a *run*, not just on a particular bank but on others too who are perceived to have weakness or even similar business models. The non-bank financial intermediaries who lose the trust of their lenders would not be able to raise resources at a reasonable cost making it hard for them to operate efficiently and profitably. All these can lead to snowballing effect impairing the functioning of the entire financial system due to interconnectedness. Good governance ensures customers' and

other stakeholders' trust in banks and non-banking financial intermediaries.

- d. Among the financial intermediaries, banks occupy a special place due to their centrality in the transmission of monetary policy and the functioning of the payment and settlement systems. They also are the beneficiaries of deposit insurance which may weaken their incentive for strong management monitoring as well as monitoring by other stakeholders including depositors. Good corporate governance would ensure strong internal controls which would offset the weakened incentive for monitoring. A robust and stable banking system is an absolute necessity for a well functioning economy.

#### **Corporate Governance – International Experience**

7. Academic literature suggests that post-2000, significant developments happened in the corporate governance framework internationally. For example, in the US, corporate scandals including Enron and World Com resulting from failure in corporate governance, led to Sarbanes–Oxley Act with an aim to improving the accuracy and reliability of corporate disclosures by way of enhanced oversight role of Boards, corporate responsibility, certification of accuracy of financial transactions by Top Management, setting standards for auditor independence, *etc.*

8. However, it is widely acknowledged that even the enhanced framework could not mitigate the weaknesses which played a significant role in contributing to the global financial crisis (GFC). There are ongoing debates regarding the manner in which flawed governance practices played their part in the crisis. While poor implementation is blamed by some, systemic failure of corporate governance is attributed by others as the cause. OECD and UK Financial Regulatory Council share the view that the shortcomings were not with the Corporate Governance codes/principles *per se*, but were in their implementation.

## Governance and Ethics

9. Lack of ethics too played a significant part in the erosion of governance standards in institutions. Values and culture define ethics. Ethics are principles that recommend proper conduct, help distinguish right from wrong and drive people to do the right thing even when no one is looking. While ethical behaviour is a minimum requirement for any dealing or transaction, it becomes all the more essential for financial intermediaries, and particularly for banks, for whom trust is the cornerstone. Honest and prudent behaviour by banks and other financial intermediaries is integral to their reputation and public confidence in the system.

10. However, the conduct of financial institutions that caused the crisis does not suggest any measure of enduring interaction between ethics and banking. In fact, financial markets and entities displayed significant moral bankruptcy through the period spanning pre-crisis, crisis year and beyond.

11. Some of the recent high profile events have emphatically highlighted the complete lack of ethics in some financial institutions. London interbank offered rate (LIBOR) rigging episode wherein a few financial institutions colluded in rigging the LIBOR so as to profit from the trades or to give an inflated impression about their creditworthiness shook the world. LIBOR is one of the most important interest rates and is used for pricing of about US\$ 800 trillion worth of financial instruments (reportedly 11 times the GDPs of all nations on earth). There are several such episodes.

12. Closer home too, in India, we have witnessed a few high profile cases which have shaken the public trust in the financial system. Satyam, once regarded as having good corporate governance, was found to have been deeply involved in one of India's biggest corporate frauds. The 1992 securities scam which brought out the nexus between bankers and brokers led to massive overhaul of the financial system in India. The unethical practices adopted by some banks in recent past in selling inappropriate financial products (exotic

derivatives) to their corporate customers and the unfair and unscrupulous methods adopted by some microfinance institutions (MFIs) in their operations are some recent reminders of erosion of ethics in the financial system.

## Causes of governance failure

13. A systemic failure of corporate governance means the failure of the whole set of regulatory, market, stakeholder and internal governance, which has largely contributed to the on-going financial crisis<sup>4</sup>.

- a. *Regulatory governance failure*: The regulatory framework in the pre-crisis period was veering more towards deregulation and liberalisation. The Chinese wall that separated investment banking from retail banking was brought down with the repeal of Glass-Steagall Act of 1933 which led to the proliferation of universal banks. While this enabled the institutions to achieve economies of scale and scope, it also led to transmission of risks of investment banking into retail banking. The exemption from regulation of OTC derivatives enabled by the passage of Commodity Futures Modernisation Act 2000 is alleged to have encouraged excessive trading in Credit Default Swaps which were an important feature of the global crisis. Other regulatory dispensations such as permitting banks to move massive amounts of assets and liabilities off balance sheet through structured investment vehicles also fuelled the crisis. Further, the regulatory gaps which led to proliferation of shadow banking entities have also been significantly instrumental in exacerbating the crisis. There were lapses in the supervisory framework also. In the run-up to the crisis, it was observed that the supervisors were staying on the sidelines and not intruding sufficiently into the affairs

<sup>4</sup> Sun, William, Stewart, Jim and Pollard, David; 'A systemic failure of corporate governance: Lessons from the on-going financial crisis'.

of participants. They were not being proactive in dealing with the emerging risks and in adapting to changing environment. There was a lack of capacity to identify, or to act on identification. For example, supervisors could not see the risks building up when banks started dealing in very complex products or when banks started relying excessively on short term funding sources for their operations. Supervision was not comprehensive and even when supervisors found some anomaly, it was not taken to conclusion.

- b. *Market Governance failure:* The prevailing dogma prior to the crisis was that markets were always right and will find their own balance, left to themselves. There was unflinching faith in the invisible hand of markets, despite the well known fat tails in statistical distributions representing herd behaviour of markets signifying irrationality driven by excessive optimism or pessimism. However, the crisis established that markets are indeed fallible. As observed by Joseph E. Stiglitz, a Nobel laureate in economics, when information is imperfect, markets do not often work well and information imperfections are central in finance.
- c. *Stakeholder governance failure:* The crisis has also highlighted the failure on the part of various stakeholders who did not have active involvement in corporate governance.
- d. *Internal Governance failure:* It is observed that the lapses in internal systems and controls such as Board oversight, managerial competence, compensation policies, audit *etc.* were instrumental in exacerbating the crisis.

14. Let me now briefly touch upon some of the specific internal governance failures in the financial institutions that have contributed to and/or exacerbated the crisis.

- a. *Complex and opaque organisational structures:* There was a massive growth in the complexity of organisational structures in the pre-crisis period, with a view to taking advantage of regulatory arbitrage and also of gaps in regulations. Regulators found it difficult to look through the structures and enforce regulation. Many times, such complex structures fell in the gaps between regulatory jurisdictions and escaped regulations.
- b. *Inadequate Oversight by Board:* Boards were found to be not actively involved in formulating risk appetite framework of firms. Incomplete risk information due to gaps in MIS coupled with inadequate understanding of risk due to the lack of expertise among the directors, hampered effective and timely decision making. Improper pricing of risk led to suboptimal allocation of capital and inadequate preparation for the tail events eventually leading to the precipitation of the crisis.
- c. *Weaknesses in the Senior Management:* Senior management failed to adopt and integrate necessary systems to identify, manage and report risk. The misalignment of incentives also resulted in the management pursuing objectives which, at times, were at cross purposes to those of the firm.
- d. *Proliferation of complex products:* There was a significant spurt in the complexity of financial products in the run-up to the crisis. Abundance of cheap liquidity prodded the participants to innovate ways to deploy the funds and earn a return. Complexity and opacity led to inadequate understanding and mispricing of risk. The long chain of transactions also obfuscated the true risks inherent in the transactions and led to a false sense of comfort.



- e. *Flawed remuneration policies:* Compensation structures which focussed excessively on short term performance incentivised managers to take excessive risks in order to meet the short term objectives at the expense of long term sustainability of the firm. Further, the framework where the participants get to keep the gains while the losses are assured to be borne by the society (either explicitly by the government guarantee or implicitly due to the inevitable governments' intervention to bail out due to systemic concerns), was an incentive for participants to take-up risky activities. Equity incentives, put in place with the objective to align managers' incentives with those of shareholders, may also have induced managers to take excessive risks.
- f. *Weak risk management systems and internal controls:* With significant developments in technology, risk management in the run up to the crisis became highly quantitative on the lines of an exact science. Models proliferated with a false assurance to capture and measure every kind of risk. It is said that economists suffered from a syndrome of *Physics envy*. The models tried to anticipate the future based on assumptions of normality and on the basis of past data. In their exuberance, quants, however, forgot that the assumption of normality does not correspond to reality, particularly, in highly stressed situations. For example, the probability of a 5-sigma loss on any given day would mean that such an occurrence should happen once in about 14,000 years (assuming 250 trading days in a year) that is much longer than the period of time that has elapsed since civilisation evolved<sup>5</sup>. During the crisis the Wall Street Journal (2007) reported that events that

models predicted would happen only once in 10,000 years, happened everyday for 3 days. Further, the assumption, or rather the dogma, which was the basis of many models, that future could be predicted on the basis of past data, led to disastrous outcomes. With the rapid development of technology, increased integration of markets and entry of sophisticated players, the present and the future are much different from the past and it would be very naïve to predict the future based on the past data.

- g. *Inadequate emphasis on financial literacy and consumer protection:* While the complexity of financial products was increasing, inadequate attention was paid to imparting financial education to the public. Financial literacy would not only to enable customers to make use of the available products but, more importantly, help them understand the inherent risks in the products and to guard themselves if the financial institutions indulged in mis-selling and other unfair practices.

#### **International initiatives in strengthening corporate governance**

15. Global crisis has highlighted the significance of good corporate governance for the survival and well functioning of financial institutions. The Senior Supervisors' Group's Report '*Observations on Risk Management Practices during the Recent Market Turbulence*' (March 2008) confirms that the financial institutions which survived the crisis better were those who had, among others, informative and responsive risk measurement and management reporting and practices. The blend of qualitative and quantitative analysis provided a high level of insight and consistent communication to management of evolving conditions, enabling the firm to respond effectively to emerging opportunities and risks.

<sup>5</sup> Dowd, Kevin and Hutchinson, Martin, '*Alchemists of Loss*', Times Group Books.

16. With lessons drawn from the crisis, policy makers have revisited the extant corporate governance framework and have issued guidance with a view to addressing the gaps witnessed and strengthening the governance framework. The OECD Steering Group on Corporate Governance, which examined the governance failures, observed that while the corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of global crisis, the OECD Principles of Corporate Governance issued in 2004, nevertheless, provided a good basis to adequately address the key concerns that have been raised and that there was no urgent need for them to be revisited. The Group opined that the more urgent challenge was to encourage and support the implementation of already agreed international and national standards including the OECD Principles of Corporate Governance. Basel Committee on Banking Supervision (BCBS) has revisited its 2006 guidance on corporate governance and brought out *Principles for enhancing corporate governance* (October 2010). The Financial Stability Board (FSB) has, in its progress report to the G20 Ministers and Governors (November 2012) also made recommendations relating to the corporate governance issues of systemically important financial institutions (SIFIs).

### **Risk Governance**

17. There is an enhanced realisation that the risk governance demands a holistic approach and that risk appreciation should start at the top. A strengthened management information system (MIS) supported by robust information technology platform is a necessary pre-condition for enhancing Board efficiency in oversight and decision making. Similarly, augmented skill sets and experience at the level of independent directors would go a long way in enhancing the Board capacity. Strong MIS facilitates risk reporting to the boards in an effective and comprehensive manner, which in turn enhances transparency and causes informed decision taking. Robust information

technology systems are a necessary condition for supporting the MIS framework as the quality of risk information that the Boards and the top management receive depends largely on the quality and robustness of the information technology systems<sup>6</sup>.

18. In addition to prescribing the risk appetite for the institution, the board also needs to lay down appropriate risk strategy and ensure that this is institutionalised throughout the organisation. This would entail, aligning risk management processes with the overall business strategy, clearly defining the roles and responsibilities down the hierarchy, establishing accountability and reinforcing change with communication and training. The Board and the senior management oversight must be supplemented with effective leadership by the Chairman and the chief executive officer (CEO), and informed non-executive directors. The Boards must get much more intimately involved in risk matters and have a firmer understanding of the key risks faced by the business.

19. Effective risk governance also demands that each director is aware of the breadth of risks faced by the bank. Directors add value to the Board when they have financial expertise, are aware of risk fundamentals and techniques, and are able to manage dynamics with executives.

20. Board level risk committees have an important role to play in the overall risk governance framework. Apart from monitoring the firm's strategic-risk profile on an on-going basis, such committees would also be responsible for defining the firm's overall risk appetite; approving major transactions above a firm's risk threshold, and; establishing limit structures and risk policies for use within individual businesses.

21. Presence of a Chief Risk Officer (CRO) is expected to strengthen the risk management framework. However, independence of the CRO, with necessary stature to influence decisions, would be a critical

<sup>6</sup> Group of Thirty, 'Toward Effective Governance of Financial Institutions'

element in ensuring the effectiveness of the post in risk management process as also the strategic risk management related decisions. The CRO must report directly to the CEO and the Board and be responsible for all risks, risk management and control functions. Another important requirement is integrating risk with business strategy and compensation. Risk – and return on risk – need to be core component of any performance measure, and should be explicitly factored into incentive and compensation schemes. Compensation must be formally aligned with actual performance, such as through adding more rigorous risk-based measures to scorecards. This would also involve moving to longer vesting periods, and increasing deferred compensation.

22. The fragmented organisation of risk data into separate silos slows down risk management process and hinders the capability to respond to new regulatory requirements. The financial crisis has pushed both supervisors and market players to move towards an integrated approach to risk data that brings down the silos in organisation. Only by integrating data models, processes and methodologies can a bank achieve higher performance in terms of data quality.

23. The risk management systems must take into account the technical limitations of risk models, such as Value at Risk (VaR). Stress testing and scenario analysis need to be established as truly effective management tools and should be integrated and standardised across business lines, types of risk and asset classes.

### **Financial Stability Board (FSB)'s thematic review on risk governance**

24. The Financial Stability Board (FSB) in its Thematic Review on Risk Governance<sup>7</sup> has observed that since crisis, national authorities have taken several measures to improve regulatory and supervisory oversight of risk governance at financial institutions such as developing or strengthening existing regulation or guidance, raising

supervisory expectations for the risk management function, engaging more frequently with the board and the management, and assessing the accuracy and usefulness of the information provided to the Board to enable effective discharge of responsibilities. The evaluation also found that in many jurisdictions, the governance practices are more advanced than those prescribed under national guidance. This, the report opined, may have been motivated by firms' need to regain market confidence rather than regulatory requirements. The results of the Review support the finding that the firms in the regions hardest hit by the financial crisis have made the most progress.

25. However, there are significant gaps relative to the criteria developed, particularly in risk management. The report points to the differences in progress across regions. While firms in advanced economies have adopted more of the desirable risk governance practices, nearly 65 per cent of the firms that reside in emerging market and developing economies (EMDEs) did not meet all of the criteria for the risk management function. The report notes that more work needs to be done in the areas such as elevation of CRO position, establishment of an effective risk appetite framework (RAF), improving the chief audit executive (CAE)'s access to directors beyond those on the audit committee, *etc.*

### **Indian Scenario**

#### ***Corporate Governance of Banks***

26. Banking regulation in India shifted from prescriptive mode to prudential mode in 1990s, which implied a shift in balance away from regulation and towards corporate governance. Banks are accorded greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. This freedom necessitated tighter governance standards requiring bank boards to assume the primary responsibility and the directors to be more knowledgeable and aware and also exercise informed

<sup>7</sup> Financial Stability Board (Feb 2013), *Thematic Review on Risk Governance, Peer Review Report*.

judgement on various strategies and policy choices. With a view to strengthen corporate governance, over a period of time, various guidelines have been issued in matters relating to the role to be played by the Board, fit and proper criteria for the directors of banks, bifurcation of the post of Chairman and Managing Director (CMD), remuneration *etc.*

27. Recognising that ownership of banks by one or few individuals could be detrimental to the public interest, especially, depositors' interests, it is stipulated that, in India, banks should have a diversified ownership model. To ensure that ownership and control of banks are well diversified, guidelines on ownership and governance in private sector banks were issued by the Reserve Bank in February 2005. Another important regulatory prescription in this regard is the requirement of Reserve Bank's prior approval for any acquisition of shares in private sector banks resulting in a shareholding of 5 per cent or more of the total paid up capital of the bank.

28. The importance of diversified ownership is also underlined in the recent guidelines on new bank licenses wherein it is stipulated that Non-Operative Financial Holding Companies (NOFHC) which set up new banks should, after the initial lock in period of five years, bring down their equity capital of the bank from the minimum 40 per cent while setting up to 15 per cent within 12 years. To ensure 'Fit and Proper' status of the groups that would set up new banks, it is also stipulated that entities/groups should have a past record of sound credentials and integrity, be financially sound with a successful track record of 10 years.

#### ***Corporate Governance of Non-Banking Finance Companies (NBFCs)***

29. Traditionally, Non-Banking Finance Companies (NBFCs) in India were small family run businesses some of which accepted deposits and engaged mainly in activities such as lending. Over the years, the NBFC sector has not only grown in size but also in terms of interconnectedness and systemic importance. Today,

even though the sector has a total asset size constituting just above 12 per cent of that of scheduled commercial banks, some of the NBFCs have grown very big and are operating as conglomerates with business interests spread across insurance, broking, mutual fund, real estate, *etc.*

30. Keeping in consideration the growing significance of NBFCs in the financial system and their interconnectedness with the banking sector there is a strong case for strengthening their governance framework so as to not only protect the individual institutions and their depositors, but also to ensure the stability of the entire financial system. Further, NBFCs have exposures to sensitive sectors such as real estate and capital markets and they also rely on wholesale funding, all of which point to the requirement of robust internal controls and governance framework to ensure their stability.

31. During the crisis, while none of the shortcomings as observed globally during the GFC manifested in any significant way in the Indian NBFC sector, a temporary crisis of confidence did emanate which affected some of the NBFCs. The lack of confidence exposed the shortcomings in the funding model and consequent problems in the overall risk management framework of these NBFCs which were relying heavily on short term wholesale sources such as mutual funds to fund long term assets.

32. Further, certain shortcomings in the corporate governance were observed in a section of NBFCs *viz.*, those in the microfinance institutions (MFI) sector, leading to near collapse of the sector. Distorted financial incentives such as short term profit maximisation/undue profiteering and excessive managerial compensation that were the hallmarks of the GFC were the leading contributors to the MFI crisis. The corporate governance issues in the MFI sector were exacerbated by some of the '*for profit*' MFIs, dominated and controlled by promoter shareholders which led to inadequate internal checks and balances over executive



decision making and conflict of interests at various levels. Other undesirable practices such as connected lending, excessively generous compensation for senior management and founders/directors and the failure of internal controls leading to frauds, precipitated the crisis. Some of the MFIs are also alleged to have chased high growth trajectory at the expense of corporate best practices.

33. While drawing comparisons between the US subprime crisis and Indian MFI crisis, in an article titled '*Microfinance Industry in India: Some thoughts*' in Economic and Political Weekly (EPW) (October 8, 2011), Dr. Y. V. Reddy, former Governor, RBI, had observed that opaque practices, high salaries and commissions including unethical business and leverage were prevalent in MFIs.

34. Recognising the significance of NBFCs in the overall financial system, measures were undertaken to strengthen the regulatory framework in terms of stipulation of capital adequacy and exposure norms in 2006. Subsequently in 2007, guidelines on corporate governance for NBFCs were issued by the Reserve Bank of India. The listed NBFCs were already required to comply with the provisions of the Listing Agreement of the Securities and Exchange Board of India (SEBI), others being governed by the relevant provisions in the Companies Act, 1956.

35. While the frameworks laid down by the various regulators/Companies Act may appear similar and overlapping in some areas, there are a few differences. Companies Act does not differentiate between financial, non-financial companies and SEBI Guidelines are generally from the perspective of investor protection with emphasis on disclosure and transparency. Therefore, RBI being the prudential regulator of NBFCs, additionally lays emphasis on risk management framework and the business practices *etc.* and its framework is mainly from the angle of depositor/customer protection. Reserve Bank's guidelines on corporate governance are applicable to only NBFCs with

certain threshold of business, *i.e.*, with a certain deposit base or asset size.

### **Recent developments in NBFC sector**

36. The Reserve Bank has recently issued draft guidelines on corporate governance of NBFCs based on the recommendations of the Working Group on the issues and concerns in the NBFC sector (Chair: Ms. Usha Thorat). The guidelines aim to fine tune the framework for NBFCs by aligning the same with the businesses that they deal in and the growth in size, interconnectedness and systemic importance of the sector. The Guidelines address issues such as multiple directorships, continuing due diligence process with a reporting requirement to RBI, self certified '*fit and proper*' criteria and disclosures that are specific to NBFCs' business, such as disclosures on provision coverage ratio, Asset Liability profile, movement of NPAs, off-balance sheet exposures, structured products issued by them *etc.* Other requirements include prior approval of RBI for change in control of any registered NBFCs. It is indicated that big NBFCs with asset size of Rs. 1000 crore and above would require prior approval of RBI for appointment of CEO and would need to comply with Clause 49 provisions (of SEBI listing agreement) even if unlisted. NBFCs with asset size of Rs. 100 crore and above would be required to comply with the disclosure requirements specified in Clause 49 and of certain financial indicators.

37. Given the recent episodes in the MFI sector, the corporate governance guidelines for MFIs have also been revamped. Measures are aimed at checking undesirable business practices like multiple lending, alleged coercive practices and charging excessive interest rates, *etc.* The guidelines are aimed at enhancing the 'self discipline principle' in these NBFCs. Measures include pricing of credit, restricting lending to a borrower by not more than two MFIs, sharing credit information with a Credit Information Bureau, review of Fair Practices Code (FPC) *etc.* A Self Regulatory

Organisation (SRO) also is envisaged for the sector as a watchdog. While the final framework is still being evolved, the role envisaged for the present, *inter alia*, is to ensure good governance in the industry by way of client protection with enforcement powers to check violations to codes of conduct/regulations.

### Conclusion

38. Governance, like regulation, is an evolving concept and is continuously fine tuned to suit the dynamic economic and business environment. Global financial crisis has given us an opportunity for strengthening both the regulatory as well as governance frameworks, by highlighting gaps that exacerbated the crisis. There is an interesting debate over whether and how much regulation can substitute board level governance. While regulation is imposed from outside, corporate governance is internal and is more in the nature of self regulation which ensures that the principles and rules laid down by the regulations are scrupulously adhered to. Prior to the crisis, the emphasis was increasingly on self regulation through robust corporate governance so that the regulation could remain largely principle based and less prescriptive. However, serious lapses observed in governance framework during the crisis, tilted the balance in favour of more rigorous regulation. I am of the view that both regulation and corporate governance have to complement each other. Effective regulation furthers corporate governance and effective corporate governance ensures that the objectives of the regulation are met, with minimal regulatory intervention.

Thank you.

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