*Ethics and Corporate Governance: The Regulatory Perspective**

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Introduction

At the outset, let me congratulate the organisers for this topical choice of subject, one which concerns us all. I thank Director, National Institute of Securities Markets, Dr. Sandip Ghose and the Institute of Company Secretaries for having me here and my dear friend, Prashant Saran, for that brilliant opening address, which quite sets the tone for this panel.

Que Custodiet Ipso Custodes? Who will guard the guards ?

Over the last two decades, corporate governance has attracted a great deal of public interest, it is now widely appreciated that this is critical for the economic health of corporations and of larger society. The headlines of newspapers of the past few years in particular, portray a dismal story of lack of corporate ethics: Satyam, Enron, falling stock markets, corporate failures, dubious accounting practices, abuses of corporate power, criminal investigations reflect that the entire economic system on which investment returns depend is showing signs of infirmity and stress that have undermined investor confidence. Almost as if checks and balances that should protect our interests are pushed to one side, driven by the overwhelming need to move fast in relentless pursuit of profits. Notably, some failures were the result of fraudulent accounting and other illegal practices, others were just bad governance.

Company Boards or Old Boy's Clubs?

Company Boards often deteriorate to being a cosy club, friends of the boss, who just met to rubber stamp his decisions. I read the Economist (of 7th December) on flight, and the turn of phrase (on page 67) was interesting. Critics have compared directors to 'parsley on fish', decorative but ineffectual; or honorary colonels, ornamental in parade but fairly useless in battle. Ralph Nader calls them 'cuckolds' who are always the last to know when managers have erred.

The corporate scandals of the early 2000s forced boards to take a more active role. The Sarbanes-Oxley Act of 2002 and the New York Stock Exchange's New Rules in 2003 obliged directors to take more responsibility for preventing fraud and self-dealing. This led to a big increase in the quality of boards. But it also wasted a lot of talent on form-filling and box-ticking. Many of the same companies exhibited actual corporate governance risks such as conflicts of interest, inexperienced directors, overly lucrative compensation, or unequal share voting rights. In the face of such scandals and malpractices, there has been a renewed emphasis on corporate governance.

OECD definition of Corporate Governance

'*Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions in corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance*'.

Thus corporate governance includes within its ambit, the relationship of a company to its shareholders and to society; the promotion of fairness, transparency and accountability; reference to mechanisms that are used to '*govern*' managers and to ensure that the actions taken by them are consistent with the interests of key stakeholder groups. The salient features span issues of transparency and accountability, the legal and

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regulatory environment, appropriate risk management measures, information flows, the responsibility of Senior Management and the Board of Directors.

The Banking Regulation Act

Section 10A of the Banking Regulation Act lays down stipulations for the Board of Directors. They must have special knowledge of the following

- Accountancy
- Agriculture and Rural Economy
- Banking
- Cooperation
- Economics
- Finance
- Law
- Small Scale Industry
- Or any other matter, the special knowledge of, and practical experience in which, in the opinion of the Reserve Bank, would be useful to the Banking Company. Provided that out of the aforesaid number of Directors, not less than two shall have special knowledge of, practical experience, with respect to agriculture and the rural economy, cooperation or small scale industry and shall not (i) have substantial interest in, or be connected with, whether as an employee, manager or managing agent,
- Any company, not being a company registered under section 25 of the Companies Act, 1956 (Act No.1 of 1956), or
- Any firm, which carries on any trade, commerce or industry and which, in either case, is not a small scale industrial concern, or (ii) be proprietors of any trading, commercial or industrial concern, not being a small scale industrial concern.

Voting rights will be distributed amongst the Board of Directors in a manner such that no more than three Directors are entitled to exercise voting rights in excess of 20 per cent of the total voting rights of all the shareholders to the banking entity.

The tenure of Directors except the Chairman or the whole time Director is limited to eight continuous years.

The Chairman of the Board (appointed on a whole time basis) or the Managing Director of the banking entity and any Director (appointed by the Reserve Bank under Section 10A of the Banking Regulation Act) will not be required to hold qualification shares in the banking entity.

The RBI has the power, from time to time, to appoint one or more persons to hold office as additional Directors of any banking company, if it is of the opinion that the same is in the interests of banking Policy/public interest/banking company depositors, it may also require the banking company to elect or appoint any other person as the Chairman in case it is of the opinion that the current elected Chairman is not a fit and proper person to hold such office.

Requirements of Corporate Governance as per the RBI guidelines on Corporate Governance

RBI issues guidelines on corporate governance for public sector banks which serve as a base for the corporate governance framework in banks.

Banks must perform due diligence of the Directors in regard to their suitability for appointment to the Board by way of qualifications and technical expertise. The Government should also be guided by certain 'fit and proper' norms for the appointment of Directors representing the Government on the Boards of public sector banks.

Banks need to elect shareholder nominees in proportion to the shares issued to public subject to a maximum of six nominees in respect of banks which have issued capital to public up to 40 per cent of the banks paid-up capital.

Executive Directors (EDs) are eligible for appointment as Chairman of the Board of Directors on fulfilment of the following criteria vesting in having served in the position and residual tenure.

Guidelines on the number of EDs – Small Banks with business of less than ₹1.5 lakh crore may have two EDs with the responsibilities of the second Director including human resource development and technology. Large banks with business of more than ₹3 lakh crore may have three EDs, the third with responsibility for HRD and Technology.

I have been a Director on the Board of Andhra Bank, I found that the Boards of banks are hedged with innumerable Committees – there are Management Committee, Credit Approval Committee, Audit Committee, Risk management Committee, Special Committee to monitor large Value Frauds/Anti-Fraud Committee, Asset Liability Committee, Customer Service Committee, Shareholders Investors Grievance Committee, Share Transfer Committee, Remuneration Committee and so on and so forth and yet the state of Management and Corporate Governance in public sector banks remains a cause of grave concern.

As Deputy Governor, Dr. Chakrabarty, recently pointed out (Bancon address), if restructured assets show further deterioration surely the appraisal mechanisms were weak RAROC Risk adjusted Return on Capital was not correctly computed. The mechanisms of corporate governance surely merit much greater attention.

Regulator as Supervisor

Banks constitute the largest financial intermediaries globally and possess stupendous powers of leverage. The RBI plays a direct role in bank governance through the regulation and supervision of banking institutions. This role assumes greater salience viewed in conjunction with the need to ensure systemic and financial stability. Banks enjoy the benefit of high leverage with the downside protection of deposit insurance which weakens their incentives for strong management. They also remain 'Too Big to Fail (TBTF)'.

The current Basel accord lays even greater stress on risk measurement and management. Bank supervisors must make the Boards of banks the main locus of accountability and assess board effectiveness. Regulatory and supervisory systems that foster more accurate information disclosure and empower private investors, legal rights, substantially boost banking system and profitability. Large investors may manipulate the firm contrary to the Broad interests of banks and other shareholders.

The task of the bank supervisor is indeed onerous. Information asymmetries plague all sectors but this is even more tangential in finance; in product or other service markets, purchasers part with money in exchange for something new. In finance, money is exchanged for a promise to pay in the future. In many product or service markets, if the product sold – a car or a haircut is defective, the buyers often find out relatively soon. However, loan quality is not readily observable for quite some time and can be hidden for extensive periods. Banks can also alter the risk composition of their assets more quickly than most non-financial industries. Banks can also sweep problems under the carpet by extending further loans to clients that cannot service previous debt obligations. In most sectors where there is an inventory pileup, be it cars or computers, it is generally a negative sign about the company's performance but when inventories of money pile up in a bank, it becomes more liquid.

It is much harder to sort out whether this is a negative signal or a prudent response by management to a risky environment. Corporate governance of banks is an essential element of sound regulatory architecture. The regulatory response is an imperative of ethics.

Is the Business of Business just Business?

Milton Friedman had a view that corporate executive's responsibility generally will be to make as much money as possible while conforming to their basic rules of the society, both, those embodied in law and those embodied in ethical custom. The objective is the maximisation of consumption and production. 'The business of business is just business'. This is not an axiom one can concur with. If you consider the business of Companies historically, it has embraced colonialism and slavery! So the element of ethics must always underlie necessity of both business personal and organisational conduct.

Formal Codes of Ethics

While many of the governance issues that organisations face are not new, the environment in which they confront them today is more challenging than ever. Many companies are adopting legal compliance mechanisms which address ethics or conduct issues in formal documents.

RBI ethics@work

The RBI, with the assistance of Professor Dipankar Gupta, who is also a Director on the RBI Central Board, has formulated a Code of Conduct for itself, which we term ethics@work. You may well ask, why an ethics manual and I quote from the ethics manual

'An Ethics Manual promotes:

- Solidarity among colleagues;
- Pride and commitment to working for the organisation;
- Personal aspirations that are aligned with organisational goals.'

The ethics manual is expected

- To define and clearly set out what will be deemed to be acceptable behaviour.
- We hope that this will promote and ensure high standards of practice.
- And also establish a benchmark for self-evaluation.
- Lay down the mainframe for professional behaviour and responsibilities.
- Enable a sense of occupational identity ideals we can clearly ascribe to.

The written code of ethics will be useful for socialisation of our new recruits in the organisation, serve as an implement of employee training. Be a benchmark transgression of the same, will invite disciplinary action. It will also help in dispute and conflict management. The moral dilemmas, the approach-approach conflicts will be more easily resolved with reference to the touchstone of the code of ethics. It clarifies the organisation's expectations from the employee and vests on enshrining complete transparency. This is a formal code of business conduct and ethics, to be ascribed to and strictly adhered to by all employees. It is morally incumbent upon them to do so.

Some organisations also have ethics officers but in the ultimate analysis, the foundations of ethical behaviour go well beyond corporate culture and policies. These are rooted in one's moral training, lessons parents and school teachers have taught from early childhood on which affect not just individual behaviour the competitive business environment and indeed society as a whole.

Conclusion

From an ethical dimension, at a fundamental level, the key issues of corporate governance involve questions concerning relationships and building trust (both within and outside the organisation). Aristotle, in the *Nichomacnean Ethics* explained that it is 'in justice' that the ordering of society is centered.

Ethics comes from the Greek ethos and embraces both work ethics and 'mores' – the conduct and culture of the organisation. It is therefore all encompassing and must be all pervasive.