

## **Corporate Governance**

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I am happy to be here today. I am happy to be here in this historic city of Hyderabad, which is known as the training capital of India and equally happy to be in this prestigious campus of Administrative Staff College of India, nationally acclaimed as a temple of learning and temple of training. I thank my good and esteemed friend Dr. E.A.S Sarma-a well-known administrator, intellectual, economist and academician for giving me this wonderful opportunity of addressing this enlightened gathering on 'Corporate Governance'- a topic of tremendous relevance, focus and significance in the present day context.

Speaking on the Corporate Governance I am reminded of the Union Finance Minister's observation on the subject a few months back. The Honourable Union Finance Minister, Shri Yashwant Sinha, while inaugurating the 17<sup>th</sup> Annual Session of FICCI Ladies Organisation (FLO), stressed the need to formulate and adhere to a set of strong corporate governance practices. He was addressing the august audience of leading businesswomen of FICCI on "The Emerging Need for Corporate Governance".

He said and I quote : "Today we need a pragmatic approach rather than a narrow doctrinaire approach to serve our needs. It is essential that we have high ethical standards of corporate governance, followed voluntarily, having community sanctions which will have much more effectiveness. Only then our endeavor at economic reforms and liberalisation will fructify"- unquote.

Finance Minister exhorted the business leaders to set up examples in corporate governance of high ethical standards, which will create better value for all the stakeholders and will lead to growth, which in effect will help the country to fight poverty and debilitating diseases. This alone, he felt, will enable the Government to justify the efforts at liberalisation and bringing in economic reforms.

A social institution, including a corporate entity, derives its legitimacy from its ability and desire to fulfill social needs. It is therefore, accountable to the society. No institution, however high and mighty it is, can ignore its responsibility towards the society from which it derives its strength and sustenance.

The recurring financial crises and the scams that rocked the nation in the recent past call for a sharper focus on corporate governance. The only way we can protect our interest and also those of the public at large is to build "firewalls" by putting in place the practices of good corporate governance.

### **WHAT IS CORPORATE GOVERNANCE ?**

Corporate Governance has succeeded in attracting a good deal of public interest because of its importance for the economic health of corporations and the welfare of society, in general. However, the concept of corporate governance is defined in several ways because it potentially

covers the entire gamut of activities having direct or indirect influence on the financial health of the corporate entities. As a result, different people have come up with different definitions, which basically reflect their special interests in the field. So I feel, the best way to define the concept is perhaps to list a few of the different definitions rather than mentioning just one or two.

Before attempting to do this, it would be useful to recall the earliest definition of Corporate Governance by the Economist and Noble laureate Milton Friedman. According to him, "Corporate Governance is to conduct the business in accordance with owner or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs". This definition is based on the economic concept of market value maximisation that underpins shareholder capitalism. Apparently, in the present day context, Friedman's definition is narrower in scope. Over a period of time the definition of Corporate Governance has been widened. It now encompasses the interests of not only the shareholders but also many stakeholders.

Let us take a look at the other definitions in the context of the present day situation.

#### SOME OTHER DEFINITIONS :

1. According to some experts "Corporate Governance means doing everything better, to improve relations between companies and their shareholders; to improve the quality of outside Directors; to encourage people to think long-term; to ensure that information needs of all stakeholders are met and to ensure that executive management is monitored properly in the interest of shareholders".
2. Experts of the OECD have defined Corporate governance as the system by which business corporations are directed and controlled. According to them 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 on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and also provides the means of attaining those objectives and monitoring performance. OECD's definition, I feel, is consistent with the one presented by Cadbury Committee.
3. An article published in the June 21, 1999 issue of the Financial Times quoted J. Wolfensohn, President, World Bank as saying that "Corporate Governance is about promoting corporate fairness, transparency and accountability"

And

4. According to some economists, Corporate Governance is a field in economics that investigates how corporations can be made more efficient by the use of institutional structures such as contracts, organisational designs and legislation. This is often limited to the question of shareholder value *i.e.*, how the corporate owners can motivate and/or secure that the corporate managers will deliver a competitive rate of return.

These are just a few definitions of Corporate Governance. However it may be of interest to know the genesis of the subject (Corporate Governance) and in this context I would like to briefly share with you the historical perspective.

## HISTORICAL PERSPECTIVE

The seeds of modern Corporate Governance were probably sown by the Watergate scandal in the United States. As a result of subsequent investigations, U.S. regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control.

This was followed in 1979 by the Securities and Exchange Commission of USA's proposals for mandatory reporting on internal financial controls. In 1985, following a series of high profile business failures in the USA, the most notable one of which being the Savings and Loan collapse, the Treadway Commission was formed. Its primary role was to identify the main causes of misrepresentation in financial reports and to recommend ways of reducing incidence thereof. The Treadway report published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective Internal Audit function. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organisations to develop an integrated set of internal control criteria to enable companies to improve their controls.

Accordingly COSO (Committee of Sponsoring Organisations) was born. The report produced by it in 1992 stipulated a control framework which has been endorsed and refined in the four subsequent U.K. reports: Cadbury, Ruttman, Hampel and Turnbull. While developments in the United States stimulated debate in the U.K., a spate of scandals and collapses in that country in the late 1980s and early 1990's led shareholders and banks to worry about their investments. These also led the Government in U.K. to recognise that the then existing legislation and self-regulation were not working.

Companies such as Polly Peck, British & Commonwealth, BCCI, and Robert Maxwell's Mirror Group News International in U.K. were all victims of the boom-to-bust decade of the 1980s. Several companies, which saw explosive growth in earnings, ended the decade in a memorably disastrous manner. Such spectacular corporate failures arose primarily out of poorly managed business practices.

It was in an attempt to prevent the recurrence of such business failures that the Cadbury Committee, under the chairmanship of Sir Adrian Cadbury, was set up by the London Stock Exchange in May 1991. The committee, consisting of representatives drawn from the top levels of British industry, was given the task of drafting a code of practices to assist corporations in U.K. in defining and applying internal controls to limit their exposure to financial loss, from whatever cause.

## CADBURY COMMITTEE

The stated objective of the Cadbury Committee was “to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them”.

The Committee investigated accountability of the Board of Directors to shareholders and to the society. It submitted its report and associated “Code of Best Practices” in December 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability.

The resulting report, and associated “Code of Best Practices,” published in December 1992, was generally well received. Whilst the recommendations themselves were not mandatory, the companies listed on the London Stock Exchange were required to clearly state in their accounts whether or not the code had been followed. The companies who did not comply were required to explain the reasons for that.

The Cadbury Code of Best Practices had 19 recommendations. Being a pioneering report on Corporate Governance, it would be in order to make a brief reference to them. The recommendations are in the nature of guidelines relating to the Board of Directors, Non-executive Directors, Executive Directors and those on Reporting and Control.

Relating to the Board of Directors these are:

- The Board should meet regularly, retain full and effective control over the company and monitor the executive management.
- There should be a clearly accepted division of responsibilities at the head of a company, which will ensure balance of power and authority, such that no individual has unfettered powers of decision. In companies where the Chairman is also the Chief Executive, it is essential that there should be a strong and independent element on the Board, with a recognised senior member.
- The Board should include non-executive Directors of sufficient caliber and number for their views to carry significant weight in the Board’s decisions.
- The Board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands.
- There should be an agreed procedure for Directors in the furtherance of their duties to take independent professional advice if necessary, at the company’s expense.
- All Directors should have access to the advice and services of the Company Secretary, who is responsible to the Board for ensuring that Board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of Company Secretary should be a matter for the Board as a whole.

Relating to the Non-executive Directors the recommendations are :

- Non-executive Directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.

- The majority should be independent of the management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding. Their fees should reflect the time, which they commit to the company.
- Non-executive Directors should be appointed for specified terms and reappointment should not be automatic.
- Non-executive Directors should be selected through a formal process and both, this process and their appointment, should be a matter for the Board as a whole.

For the Executive Directors the recommendations in the Cadbury Code of Best Practices are:

- Directors' service contracts should not exceed three years without shareholders' approval.
- There should be full and clear disclosure of their total emoluments and those of the Chairman and the highest-paid UK Directors, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.
- Executive Directors' pay should be subject to the recommendations of a Remuneration Committee made up wholly or mainly of Non-Executive Directors.

And on Reporting and Controls the Cadbury Code of Best Practices stipulate that:

- It is the Board's duty to present a balanced and understandable assessment of the company's position.
- The Board should ensure that an objective and professional relationship is maintained with the Auditors.
- The Board should establish an Audit Committee of at least three Non-Executive Directors with written terms of reference, which deal clearly with its authority and duties.
- The Directors should explain their responsibility for preparing the accounts next to a statement by the Auditors about their reporting responsibilities.
- The Directors should report on the effectiveness of the company's system of internal control.
- The Directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

#### Cadbury Committee and After

It would be interesting to note how the corporate world reacted to the Cadbury Report. The report in fact shocked many by its boldness, particularly by the Code of Practices recommended by it. The most controversial and revolutionary requirement and the one that had the potential of significantly impacting 'the internal auditing, was the requirement that the Directors should report on the effectiveness of a company's system of internal control.' It was the extension of control beyond the financial matters that caused the controversy.

Paul Ruthman Committee constituted later to deal with this controversy watered down the proposal on the grounds of practicality. It restricted the reporting requirement to internal financial controls only as against the 'the effectiveness of the company's system of internal control' as stipulated by the Code of Practices contained in the Cadbury Report.

It took another five years to get the original Cadbury recommendations on internal control reporting re-instated. Public confidence in U.K. continued to be shaken by further scandals and Ron Hampel was given the task of chairing the 'Committee on Corporate Governance' with a brief to keep up the momentum by assessing the impact of Cadbury and developing further guidance.

The Final Report submitted by the Committee chaired by Ron Hampel had some important and progressive elements, notably the extension of Directors' responsibilities to 'all relevant control objectives including business risk assessment and minimising the risk of fraud...'

The Combined Code was subsequently derived from Ron Hampel Committee's Final Report and from the Cadbury Report and the Greenbury Report. (Greenbury Report, which was submitted in 1995, addressed the issue of Directors' remuneration). The Combined Code is appended to the listing rules of the London Stock Exchange. As such, compliance is mandatory for all listed companies in the U.K.

The stipulations contained in the Combined Code require, among other things, that the Boards should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets and that the Directors should, at least annually, conduct a review of the effectiveness of the Group's system of internal control and should report to shareholders that they have done so and that the review should cover all controls, including financial, operational and compliance controls and risk management.

Subsequent developments with regard to Corporate Governance in U.K. led to the publication of Turnbull Guidance in September 1999, which required the Board of Directors to confirm that there was an on-going process for identifying, evaluating and managing the key business risks. Shareholders, after all, are entitled to ask if all the significant risks had been reviewed (and presumably appropriate actions taken to mitigate them) and why was a wealth-destroying event not anticipated and acted upon?

In this context, it was observed that the one common denominator behind the past failures in the corporate world was the lack of effective Risk Management. As a result, Risk Management subsequently grew in importance and is now seen as highly crucial to the achievement of business objectives by the corporates.

It was clear, therefore, that Boards of Directors were not only responsible but also needed guidance not just reviewing the effectiveness of internal controls but also for providing assurance that all the significant risks had been reviewed. Furthermore, assurance was also required that the risks had been managed and an embedded risk management process was in place. In many companies this challenge was being passed on to the Internal Audit function.

The corporate world in India could not remain indifferent to the developments that were taking place in the U.K. Infact the developments in U.K. had tremendous influence on our country too. They triggered the thinking process in our country, which finally led us to laying down our own ground rules on Corporate Governance.

## INDIAN EXPERIENCE

Let us see the developments in our own country in this regard.

As a result of the interest generated in the Corporate sector by the Cadbury Committee's report, the issue of Corporate Governance was studied in depth and dealt with by the Confederation of Indian Industries (CII), the Associated Chamber of Commerce and the Securities and Exchange Board of India (SEBI). Though some of the studies did touch upon shareholders' right to 'vote by ballot' and a few other issues of general nature, none can claim to be wider than the Cadbury report in scope. It will be interesting to look upon the Cadbury Model in the Indian Context.

The stress in the Cadbury report is on the crucial role of the Board and the need for it to observe a Code of Best Practices. Its important recommendations include the setting up of an Audit Committee with independent members. The Cadbury model is one of self-regulation. It was recognised that in the event British companies failed to comply with the voluntary code, legislation and external regulation would follow.

In India, the emphasis during the past few years has been limited to only some of the recommendations of the Cadbury Committee — such as the role and composition of the Audit Committees and the importance of making all the necessary disclosures with annual statements of accounts, which are considered important for investors' protection.

Some of the important initiatives taken in our country to frame the ground rules on Corporate Governance deserve a brief mention.

### Indian Studies

The CII was the first to come out with its version of an Audit Committee. The SEBI, as the custodian of investor interests, did not lag behind. On May 7, 1999, it constituted an 18-member committee, chaired by the young and forward-looking industrialist, Mr. Kumar Mangalam Birla (a chartered accountant himself), on Corporate Governance, mainly with a view to protecting the investors' interests. The Committee made twenty-five recommendations, nineteen of them 'mandatory' in the sense that these were enforceable. The listed companies as you may be aware, were obliged to comply with these on account of the contractual obligation arising out of the listing agreement with Stock Exchanges.

The mandatory recommendations of the Kumar Mangalam committee include the constitution of Audit Committee and Remuneration Committee in all listed companies, appointment of one or more independent Directors in them, recognition of the leadership role of the Chairman of a company, enforcement of Accounting Standards, the obligation to make more disclosures in annual financial reports, effective use of the power and influence of institutional shareholders, and so on. The Committee also recommended a few provisions, which are non- mandatory. Let us see these recommendations in brief:

To begin with let me share with you some of the mandatory recommendations:

- The Board of a company should have an optimum combination of executive and non-executive Directors with not less than 50 per cent of the Board comprising the non-executive Directors.
- The Board of a company should set up a qualified and an independent Audit Committee. The Audit Committee should have minimum three members, all being non-executive Directors, with the majority being independent, and with at least one Director having financial and accounting knowledge. The Chairman of the Audit Committee should be an independent Director.

I wish to add, that the board of directors is a combination of executive directors and non-executive directors. The non-executive directors comprise of promoter directors and independent directors. As you may be aware, independent directors are those, who, apart from receiving director's remuneration, do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries that in the judgement of the Board may affect their independence of judgement.

The Chairman of the Audit Committee should be present at Annual General Meeting to answer shareholder-queries.

- The Company Secretary should act as the secretary to the Audit Committee.
- The Audit Committee should meet at least thrice a year. The quorum should be either two members or one-third of the members of the Audit Committee.
- The Audit Committee should have powers to investigate any activity within its terms of reference, to seek information from any employee; to obtain outside legal or professional advice, and to secure attendance of outsiders if necessary.
- The Audit committee should discharge various roles such as, reviewing any change in accounting policies and practices; compliance with Accounting Standards; compliance with Stock Exchange and legal requirements concerning financial statements; the adequacy of internal control systems; the company's financial and risk management policies etc.
- The Board of Directors should decide the remuneration of the non-executive Directors.
- Full disclosure should be made to the shareholders regarding the remuneration package of all the Directors.
- The Board meetings should be held at least four times a year.
- A Director should not be a member in more than ten committees or act as the chairman of more than five committees across all companies in which he is a Director. This is done to ensure that the members of the Board give due importance and commitment of the meetings of the Board and its committees.
- The management must make disclosures to the Board relating to all material, financial and commercial transactions, where they have personal interest.
- In case of the appointment of a new Director or re-appointment of a Director, the shareholders must be provided with a brief resume of the Director, his expertise and the names of companies in which the person also holds Directorship and the membership of committees of the Board.
- A Board committee should be formed to look into the redressal of shareholders' complaints like transfer of shares, non-receipt of balance sheet, dividend etc.



- There should be a separate section on Corporate Governance in the annual reports of the companies with a detailed compliance report.

Apart from these, the Kumar Mangalam Committee also made some recommendations that are non-mandatory in nature as already mentioned by me above. Some of the non-mandatory recommendations are that:

- The Board should set up a Remuneration Committee to determine the company's policy on specific remuneration packages for executive Directors.
- Half-yearly declaration of financial performance including summary of the significant events in the last six months should be sent to each shareholder.
- Non-executive chairman should be entitled to maintain a chairman's office at the company's expense. This will enable him to discharge the responsibilities effectively.

It will be interesting to note that Kumar Mangalam Committee while drafting its recommendations was faced with the dilemma of statutory v/s voluntary compliance. You may also be aware that the desirable code of Corporate Governance, which was drafted by CII and was voluntary in nature, did not produce the expected improvement in Corporate Governance. It is in this context that the Kumar Mangalam Committee felt that under the Indian conditions a statutory rather than a voluntary code would be far more purposive and meaningful. This led the Committee to decide between mandatory and non-mandatory provisions. The Committee felt that some of the recommendations are absolutely essential for the framework of Corporate Governance and virtually form its code, while others could be considered as desirable. Besides, some of the recommendations needed change of statute, such as the Companies Act for their enforcement. Faced with this difficulty the Committee settled for two classes of recommendations.

SEBI, as I am sure you may be aware of, has given effect to the Kumar Mangalam Committee's recommendations by a direction to all the Stock Exchanges to amend their listing agreement with various companies in accordance with the 'mandatory' part of the recommendations.

Corporate Governance for Banking Organisations: Basel Committee Publication.

So far I have dwelt at length on the concept of corporate governance in general and the recommendations made by committees in India and abroad to strengthen the same.

Banks, as we know, are a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have strong corporate governance.

Let us have a look at the Basel Committee Publication on corporate governance for banking organisations.

Basel Committee published a paper on Corporate Governance for banking organisations in September 1999. Let me share with you some of the issues and concerns shared in that Paper. The Committee feels it is the responsibility of the banking supervisors to ensure that there is effective corporate governance in the banking industry. Supervisory experience underscores the need of having appropriate accountability and checks and balances within each bank to ensure sound corporate governance, which in turn would lead to effective and more meaningful supervision. Sound corporate governance could also contribute to a collaborative working relationship between bank managements and bank supervisors.

Basel Committee underscores the need for banks to set strategies for their operations. The committee also insists banks to establish accountability for executing these strategies. Unless there is transparency of information related to decisions and actions it would be difficult for stakeholders to make management accountable..

From the perspective of banking industry, corporate governance also includes in its ambit the manner in which their boards of directors govern the business and affairs of individual institutions and their functional relationship with senior management. This is determined by how banks :

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business and;
- consider the interests of recognised stakeholders *i.e.*, employees, customers, suppliers, supervisors, governments and the community and
- align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors.

You may be aware that the Committee has issued several papers on specific topics, where the importance of corporate governance is emphasised. These include Principles for the management of interest rate risk (September 1997), Framework for internal control systems in banking organisations (September 1998), Enhancing bank transparency (September 1998), and Principles for the management of credit risk (issued as a consultative document in July 1999). These papers have highlighted the fact that sound corporate governance should have, as its basis, the following strategies and techniques:

- the corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;
- a well-articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;
- the clear assignment of responsibilities and decision-making authorities, incorporating an hierarchy of required approvals from individuals to the board of directors;
- establishment of a mechanism for the interaction and cooperation among the board of directors, senior management and the auditors;
- strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances;

- special monitoring of risk exposures where conflicts of interest are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm (e.g. traders);
- the financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition; and
- appropriate information flows internally and to the public.

For ensuring good corporate governance, the importance of overseeing the various aspects of the corporate functioning needs to be properly understood, appreciated and implemented.

There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure the appropriate checks and balances: (1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management and audit functions. In addition to these, it is important that the key personnel are fit and proper for their jobs.

## SOUND CORPORATE GOVERNANCE PRACTICES

Banking organisations do sometimes face problems with regard to corporate governance. Supervisory experience suggests that certain practices when adopted by these organisations are quite helpful. These practices should be viewed as critical elements of any corporate governance process.

The practices I am referring to are:

- Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation.
- Setting and enforcing clear lines of responsibility and accountability throughout the organisation.
- Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.
- Ensuring that there is appropriate oversight by senior management.
- Effectively utilising the work conducted by internal and external auditors, in recognition of the important control functions they provide.
- Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment.
- Conducting corporate governance in a transparent manner.
- Ensuring an environment supportive of sound corporate governance.

I would like to discuss these practices in some detail, as dealt with by Basel Committee.

Regarding establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation, Basel Committee feels that it is difficult to conduct the

activities of an organisation when there are no strategic objectives or guiding corporate values. Therefore, the board should establish the strategies that will direct the ongoing activities of the bank. It should also take the lead in establishing the “tone at the top” and approving corporate values for itself, senior management and other employees. The values should recognise the critical importance of having timely and frank discussions on problems. In particular, it is important that the values prohibit corruption and bribery in corporate activities, both in internal dealings and external transactions.

The board of directors should ensure that senior management implements policies that prohibit (or strictly limit) activities and relationships that diminish the quality of corporate governance, such as :

- conflicts of interest;
- lending to officers and employees and other forms of self-dealing (*e.g.*, internal lending should be limited to lending consistent with market terms and to certain types of loans, and reports of insider lending should be provided to the board, and be subject to review by internal and external auditors); and
- providing preferential treatment to related parties and other favoured entities (*e.g.*, lending on highly favourable terms, covering trading losses, waiving commissions).

Processes should be established that allow the board to monitor compliance with these policies and ensure that deviations are reported to an appropriate level of management.

On the practice of setting and enforcing clear lines of responsibility and accountability throughout the organisation , Basel Committee says that effective boards of directors clearly define the authorities and key responsibilities for themselves, as well as senior management. Such boards also recognise that unspecified lines of accountability or confusing, multiple lines of responsibility might exacerbate a problem through slow or diluted responses. Senior management is responsible for creating an accountability hierarchy for the staff, but must be cognizant of the fact that they are ultimately responsible to the board for the performance of the bank.

Regarding the practice of ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns, Basel Committee stipulates that the board of directors is ultimately responsible for the operations and financial soundness of the bank. The board of directors must receive on timely basis sufficient information to judge the performance of management. An effective number of board members should be capable of exercising judgement, independent of the views of management, large shareholders or the government. Inclusion on the board, qualified directors that are not members of the bank’s management, or having a supervisory board or board of auditors, separate from the management board, can enhance independence and objectivity. Moreover, such members can bring new perspectives from other businesses that may improve the strategic direction given to management, such as insight into local conditions. Qualified external directors can also become significant sources of management expertise in times of corporate stress. The board of directors should periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective

actions.

According to the Committee the Boards of directors add strength to the corporate governance of a bank when they :

- understand their oversight role and their “duty of loyalty” to the bank and its shareholders;
- serve as a “checks and balances” function *vis-à-vis* the day-to-day management of the bank;
- feel empowered to question the management and are comfortable insisting upon straightforward explanations from management;
- recommend sound practices gleaned from other situations;
- provide dispassionate advice;
- are not overextended;
- avoid conflicts of interest in their activities with, and commitments to, other organisations; meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives;
- absent themselves from decisions when they are incapable of providing objective advice;
- do not participate in day-to-day management of the bank.

It is found that in a number of countries, bank boards have found it beneficial to establish certain specialised committees. Let us look at a few of them:

- Risk management committee: It provides oversight of the senior management’s activities in managing credit, market, liquidity, operational, legal and other risks of the bank. (This role should include receiving from senior management periodic information on risk exposures and risk management activities).
- Audit committee : It provides oversight of the bank’s internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors. The independence of this committee can be enhanced when it is comprised of external board members that have banking or financial expertise.
- Compensation committee : It provides oversight of remuneration of senior management and other key personnel and ensuring that compensation is consistent with the bank’s culture, objectives, strategy and control environment.
- Nominations committee : It provides important assessment of board effectiveness and directing the process of renewing and replacing board members.

Regarding the practice of ensuring that there is appropriate oversight by senior management, Basel Committee says that the senior management is a key component of corporate governance. Just as the board of directors provides checks and balances to senior managers, senior managers should assume the oversight role with respect to line managers in specific business areas and activities. Even in very small banks, key management decisions should be made by more than one person (“four eyes principle”).

According to the Committee, it is desirable to avoid assigning oversight functions to senior

managers who are:

- overly involved in business line decision-making;
- assigned an area to manage without the necessary prerequisite skills or knowledge;
- unwilling to discipline successful or key employees, when they go wrong, for fear of losing them;

The Paper says that the senior management consists of a core group of officers responsible for the bank.

This group should include such individuals as the chief financial officer, division heads and the chief auditor. These individuals must have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individuals in these areas.

On the practice of effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide, Basel Committee recognises the significance of auditors and says that the role of auditors is vital to the corporate governance process. The Paper says that the effectiveness of the board and senior management can be enhanced by:

- (1) recognising the importance of the audit process and communicating this importance throughout the bank;
- (2) taking measures that enhance the independence and stature of auditors;
- (3) utilising, in a timely and effective manner, the findings of auditors;
- (4) ensuring the independence of the head auditor through his reporting to the board or the board's audit committee;
- (5) engaging external auditors to judge the effectiveness of internal controls; and
- (6) requiring timely correction by management ,of problems identified by auditors.

Basel Committee casts greater responsibility on the board to recognise and acknowledge that the internal and external auditors are their critically important agents. In particular, the board should utilise the work of the auditors as an independent check on the information received from management on the operations and performance of the bank.

Regarding ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment, I would like to say that it has been strongly recommended by the Basel Committee because failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to short or long-term risk consequences. This can be seen particularly with loan officers, but can also adversely affect the performance of other support staff.

The board of directors should approve the compensation of members of senior management and other key personnel and ensure that such compensation is consistent with the bank's culture, objectives, strategy and control environment. This will help to ensure that senior managers and other key personnel will be motivated to act in the best interests of the bank.

In order to avoid incentives being created for excessive risk-taking, the salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance, such as short-term trading gains.

On the issue of conducting corporate governance in a transparent manner, Basel Committee's paper on Enhancing Bank Transparency states that it is difficult to hold the board of directors and senior management properly accountable for their actions and performance when there is lack of transparency. This happens in situations where the stakeholders, market participants and general public do not receive sufficient information on the structure and objectives of the bank with which to judge the effectiveness of the board and senior management in governing the bank.

Transparency can reinforce sound corporate governance. Therefore, public disclosure is desirable in the following areas :

- Board structure with regard to size, membership, qualifications and committees;
- Senior management structure -regarding responsibilities, reporting lines, qualifications and experience;
- Basic organisational structure- in respect of line of business structure, legal entity structure;
- Information about the incentive structure of the bank - in relation to remuneration policies, executive compensation, bonuses, stock options; and
- Nature and extent of transactions with affiliates and related parties.

Last but not the least, is the practice of ensuring an environment supportive of sound corporate governance. The Committee recognises that primary responsibility for good corporate governance rests with the boards of directors and senior management of banks; however, there are many other ways that corporate governance can be promoted:

- Governments can do so by enacting appropriate laws and enforcing them;
- Securities Regulators, Stock Exchanges – through disclosure and listing requirements;
- Auditors – through audit standards on communications to boards of directors, senior management and supervisors; and
- banking industry associations–through initiatives related to voluntary industry principles and agreement on and publication of sound practices.

For instance, corporate governance can be improved by addressing a number of legal issues, such as the protection of shareholder rights; the enforceability of contracts, including those with service providers; clarifying governance roles; ensuring that corporations function in an environment that is free from corruption and bribery; and laws/regulations (and other measures) aligning the interests of managers, employees and shareholders. All of these can help promote healthy business and legal environments that support sound corporate governance and related supervisory initiatives.

Supervisory initiatives are indeed very crucial to the issue of promoting good corporate governance. Basel Committee states in this regard, and I fully agree with it that the supervisors should be aware of the importance of corporate governance and its impact on corporate

performance. They should expect banks to implement organisational structures that include the appropriate checks and balances. Regulatory safeguards must emphasise accountability and transparency. Supervisors should determine that the boards and senior management of individual institutions have in place processes that ensure they are fulfilling all of their duties and responsibilities.

The bank's board of directors and senior management are ultimately responsible for the performance of the bank. As such, supervisors typically check to ensure that a bank is being properly governed and bring to management's attention any problems that they detect through their supervisory efforts. When the bank takes risks that it cannot measure or control, supervisors must hold the board of directors accountable and require that corrective measures be taken in a timely manner. Supervisors should be attentive to any warning signs of deterioration in the management of the bank's activities. They should consider issuing guidance to banks on sound corporate governance and the pro-active practices that need to be in place.

Sound corporate governance considers the interests of all stakeholders, including depositors, whose interests may not always be recognised. Therefore, it is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.

## FUTURE POSSIBILITIES

In this context, it would also be interesting to examine the future possibilities of strengthening Corporate Governance in India in the light of the views of experts in the field and my own experience.

In spite of the multilateral checks and controls, there is still enough scope for improvement. Undue importance, according to some experts, need not be attached to the 'independence' of the Directors in the Audit Committee. The extent of a Director's objectivity and ability to assert himself will obviously depend on various factors such as his antecedents, his relationship with the promoters of the company, the terms of his appointment, and so on.

Kumar Mangalam Committee confined itself to submitting recommendations for good Corporate Governance and left it to SEBI to decide on the penalty provisions for non-compliance. In the absence of suitable penalty provisions, as you would agree, it would be difficult to establish good Corporate Governance. Some of the penalty provisions are not sufficient enough to discipline the Corporates. For example, the penalty for non-compliance of the stipulated minimum of 50 per cent in respect of the number of directors in the Board that should be non-executive directors is delisting of shares of the company. This, I feel, would hardly serve the purpose. In fact, this would be detrimental to the interest of the investors and to the effective functioning of the capital market.

Similarly, an Audit Committee, which is subservient to the Board, may serve no purpose at all; and one which is in perpetual conflict with the Board, may result in stalemates to the detriment of the company. If a company is to function smoothly, it should be made clear that the findings and recommendations of the Audit Committee need not necessarily have to be accepted by the



Board which is accountable to the shareholders for its performance and which, under Section 291 of the Companies Act, is entitled to “exercise all such powers, and do all such things as the company is authorised to exercise and do”.

However, some functional specialists are of the considered view that whenever there is a difference of opinion and the Audit Committee’s advice is ignored or over-ruled, the Board should be required to place the facts before the General Body of shareholders at their next meeting.

Apart from these issues, there is another area, which needs to be attended to for bringing about further improvements in Corporate Governance in India. One such area is the Accounting Standards. There are some gaps in Accounting Standards, which need to be closed or narrowed down for better transparency.

### *Bridging the Gap in Accounting Standards*

One of the first and foremost demands of good corporate governance is to let investors know how their money has been used to further the interests of the company they have invested in.

The question that assumes importance here is how effectively the resources of the company are utilized for strengthening the organisation. The only available source of information regarding the affairs of a company appears to be its Balance Sheet. Yet, for obvious reasons, the Balance Sheet remains the most abused statement of several companies.

The common methods by which companies hide their wrongful practices, which are all too well known, are to use legal and accounting jargon, non-disclosure and selective adoption of only those policies that are mandatory in nature. It is only a handful of qualified persons, primarily the accountants and the other knowledgeable people, who can get to the picture behind the scenes and unmask the actual from the portrayed picture. It is in this context that the adoption of US-GAAP, which provides for rigorous Accounting Standards and disclosures, assumes relevance.

There are many areas such as consolidation of accounts, treatment of fixed assets, depreciation, R&D costs etc. where Indian Accounting Standards (IAS) are at variance with US-GAAP. However, it is heartening to note that things appear to be changing for the better on the Indian turf; thanks to the impetus towards a more transparent accounting system shown by market leaders. Recently, the Institute of Chartered Accountants of India (ICAI), as you may be aware, issued the Accounting Standard 21 (AS-21) for consolidation of accounts whereby accounts of companies will be presented along with those of their subsidiaries. This would meet the long pending demand of investors on greater transparency and disclosure.

While talking about the future possibilities another issue, which comes to my mind, is the transparency in the Private Sector.

### *Transparency in Private Sector*

The need for transparency, so far, appears to have been felt in the context of Public Sector alone.

Consequently, we have on the anvil the Right to Information Act and a modification of the Official Secrets Act. While, there is no doubt the government has to be completely transparent in its dealings, since it is dealing with public money, privately managed companies also have a wide shareholder base. They are also dealing with large volumes of public money. The need for transparency in private sector is, therefore, in no way less important than in the Public Sector.

However, private companies use “competitive advantage/company interests” as a pretext to hide essential information. Awarding of contracts, recruitments, transfer pricing (for instance through under/over invoicing of goods in intra company transfers) are the areas, which require greater transparency. Environmental conservation, redressal of customer complaints and use of company resources for personal purposes are some of the other crucial areas, which call for greater disclosure. Relevant details about these must be available for public scrutiny. Fear of public scrutiny, as you will agree, will ensure corporate governance on sound principles both in the Public as well as Private Sectors.

Apart from these important areas, another thing that comes to my mind is –

#### *Ethics and values in corporate governance*

No discussion on public affairs will be complete without a reference to Ethics and Values. The quality of corporate governance is also determined by the manner in which top management, particularly the Board of Directors, allocates the financial resources of the company as between themselves and other interest groups such as employees, customers, government etc. The basic qualities invariably expected in this regard are trust, honesty, integrity, transparency and compliance with the laws of the land. There is an increasing body of public opinion that would expect a business enterprise not only to be a mere economic unit but also to be a good corporate citizen. For this, its corporate governance must be based on a genuine respect for Business Ethics and Values.

#### RECENT DEVELOPMENTS

The Department of Company Affairs, in May 2000, invited a group of leading industrialists, professionals and academics to study and recommend measures to enhance corporate excellence in India. The Study Group in turn set up a Task Force, which examined the subject of Corporate Excellence through sound corporate governance and submitted its report in November 2000. The task force in its recommendations identified two classifications namely essential and desirable with former to be introduced immediately by legislation and latter to be left to the discretion of companies and their shareholders. Some of the recommendations of the task force include:

- Greater role and influence for non-executive independent directors
- Stringent punishment for executive directors for failing to comply with listing and other requirements
- Limitation on the nature and number of directorship of Managing and Whole-Time directors
- Proper disclosure to the shareholders and investing community
- Interested shareholders to abstain from voting on specified matters
- More meaningful and transparent accounting and reporting

- Tougher listing and compliance regimen through a Centralized National Listing Authority
- Highest and toughest standards of Corporate Governance for Listed Companies
- A code of public behaviour for Public Sector Units
- Setting Up of a Centre for Corporate Excellence.

Recently, the Government has announced the proposal for setting up the Centre for Corporate Excellence under the aegis of the Department of Company Affairs as an independent and autonomous body as recommended by the Study Group. The Centre would undertake research on Corporate Governance; provide a scheme by which companies could rate themselves in terms of their corporate governance performance; promote corporate governance through certifying companies who practice acceptable standards of corporate governance and by instituting annual awards for outstanding performance in this area. Government's initiative in promoting corporate excellence in the country by setting up such a center is indeed a very important step in the right direction. It is likely to spread greater awareness among the corporate sector regarding matters relating to good corporate governance motivating them to seek accreditation from this body. Cumulative effect of the companies achieving levels of corporate excellence would undoubtedly be visible in the form of much enhanced competitive strength of our country in the global market for goods and services.

## CONCLUSION

I would like to conclude by quoting Sir Adrian Cadbury from the preface to the World Bank Publication, Corporate Governance: A Framework for Implementation; and I quote -"Corporate governance is ... holding the balance between economic and social goals and between individual and community goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economics and discourage fraud and mismanagement." - Unquote.

Regulators have the most crucial role in improving Corporate Governance. They are in fact external pressure points. Although compliance with regulatory requirements is an ideal situation, it is not enough for ensuring good corporate governance. What is more important is the internal pressures such as peer pressure and market pressure to reach standards higher than the minima prescribed by regulatory agencies.

The road to efficiency lies in minimising regulatory prescriptions and maximising voluntary codes to ensure excellence in corporate governance.

I had in my opening remark, indicated that there is no aspect of human life, which is not touched upon by corporate entities today. Their orderly conduct is an essential prerequisite for a healthy economy. Moreover efficient Corporate Governance will contribute to increased flow of capital from abroad.

With best of efforts so far taken to strengthen corporate governance we find, alongside corporate growth, increasing incidences of vanishing companies, mismanagement, widespread shareholder

dissatisfaction, and unethical business practices with frightening regularity. The last decade also witnessed the unearthing of several scams considerably damaging the reputation of Indian corporates. No one would like to deal with tainted companies, definitely not foreign investors and collaborators.

With the opening up of the economy and to be in tune with the WTO requirements, if Indian corporates have to survive and succeed amidst increasing competition from transnational and foreign corporates, it can be only through achieving 'Excellence' in their working. The 'Excellence' I refer here are excellence in terms of administration, excellence in terms of investor return, excellence in terms of end product or service, excellence in terms of social responsibilities, excellence in terms of returns to the promoters and excellence in terms of rewards to the people who run the corporates including employees. Corporate excellence is impossible without sound corporate governance.

I believe all of us can and must play our role, in whichever role we are placed, to the best of our ability to help promote corporate governance. The frameworks provided by Cadbury, Kumar Mangalam and the Basel Committee are quite wide and extensive. Every role holder in the corporate world would be able to find his or her own specific role responsibility in this regard. So let us all devote a serious thought to it and make our own assessment of the extent to which we have so far been helping the cause of corporate governance in our respective sphere of influence. I am confident this will certainly show us the right direction and accordingly we can draw a road map for ourselves. Only with such collective effort can we succeed in putting in place in our country a fool proof system of corporate governance for the benefit of all of us individually as well as collectively.

Before I conclude, I wish to quote the words of Benjamin Franklin

“A little neglect may breed great mischief..... for the want of a nail, the shoe was lost; for the want of a shoe, the horse was lost and for want of a horse, the rider was lost and for want of a rider the war was lost.”

Little drops of water make the mighty ocean. Little acts of neglect might cause major scams. It takes only a small hole to drown a big ship. I wish to enjoin you to be careful in avoiding little neglects in order to secure the interest of all stakeholders. To me, therein lies the secret of good corporate governance and the key to Corporate Excellence.

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\* **Inaugural address delivered by Shri Vepa Kamesam, Dy. Governor, Reserve Bank of India at Administrative Staff College of India, Hyderabad at a programme on 'Governance in Banks and Financial Institutions' on November 22, 2001.**