Speech

Banking Regulation and Corporate Governance*

S. P. Talwar

The interest in corporate governance is not a new phenomenon and basic elements such as the rights and responsibilities of different participants in the life of the corporation have been dealt with in various laws of the country. The term corporate governance has been used in a variety of contexts in recent years, particularly in relation to Boards of companies listed on a stock exchange. Many of these issues also have implications for other companies that are not listed, and these include private companies and Government owned commercial enterprises. This is because, governance is at the heart of the role that all Boards of Directors play, so an understanding of what it is about and the issues involved, can provide useful insight for directors. In United States, the corporate governance issues came to the fore during the heyday of the corporate takeover activity. In contrast, in India, the debate came up mainly due to corporate failures, serious financial and other irregularities, dereliction of duties by management, etc. which led to a growing public distrust of the governance process in corporate sector. The Cadbury Committee Report created a lot of interest in India. Whereas the corporate governance debate in US had focussed on shareholder rights, the emphasis in the UK was on structure and processes and accountability. This gave rise to the question as to whom the directors are accountable. While the Cadbury Committee focussed on the responsibility of executive and non-executive directors for reviewing and reporting performance to shareholders, this has now been expanded to include parties other than shareholders such as employees, customers, suppliers and communities. However the directors being elected by share holders, are accountable to them but the directors are also responsible for relations with stakeholders. Another more recent occurrence that has highlighted importance of corporate governance is the financial turmoil in some emerging markets and developing countries. The OECD Adhoc Task Force on Corporate Governance has laid down certain principles of corporate governance. The Principles are intended to assist governments both member and non-member in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries and to give guidance and suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance. It does not seek to establish a global standard but has identified some common elements that underlie good corporate governance. These include the right of shareholders, equitable treatment of shareholders, role of stakeholders, standards of disclosure and transparency and the role of the Board.

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Banks and Corporate Governance:

Banks play a vital role in the economy and the continued strength and stability of the

banking system is a matter of general public interest and concern both in regard to its linkages with the real sector and for providing a payment and settlement system. Banks, as corporate entities, possess certain unique characteristics. As financial intermediaries, they are highly leveraged organisations and until capital standards were introduced, banks could expand business without any linkage with capital. Even with the capital ratios now prescribed, the gearing compared to other entities is significant. Another characteristic is that banks can continue to fund their operations only so long as they enjoy the confidence of the financial markets. Credit institutions are linked to each other through a complex chain of inter-bank relationships which in the event of difficulty become mechanisms for the acceleration of contagion. The failure of a major institution or a group of institutions regardless of the reason, is liable to set off through contagion the failure of other institutions and open serious risks in both the banking and financial systems. To protect small depositors, there also exists in most countries a deposit insurance/ protection scheme. While the deposit insurance system mechanism is an important factor in the stability of the banking system it can have unintended effects in terms of the moral hazard involved both from the depositor's angle and the institution covered.

Depositor protection and public policy considerations have therefore brought banks within a comprehensive regulatory and supervisory framework. The ultimate power on which the authority of most supervisors is based is the power to authorise or licence an entity to conduct a banking business and to withdraw such authorisation/licence. In order to qualify for and retain a banking licence, entities must comply with certain regulatory requirements. Regulators follow both quantitative and qualitative approaches. Among the quantitative methods, the main pillar of prudential regulation is capital adequacy. Other quantitative methods basically are prudential limits on risk taking such as liquidity requirements, limits on foreign exchange exposures, risk concentration limits, etc. Banking is however becoming complex and it has been recognised that there is need to attach importance to qualitative standards such as internal controls and risk management, composition and role of the Board and disclosure standards. In India, therefore, during the last few years, we have initiated several steps towards corporate governance. Besides RBI's own supervisory system both off-site and on-site, external auditors play a vital role in the governance and maintenance of the overall soundness of the bank.

The increasing interest in corporate governance is also due to certain other developments such as increasing participation of the public shareholders in public sector banks, the entry of new private banks and the need to access capital markets by all banks. These developments require banks to establish credible and widely accepted corporate governance arrangements, if they have to attract capital, particularly global capital. While the generally accepted principles of corporate governance would also apply to banks, in view of their unique status and safety nets provided to them, certain principles of corporate governance require a reorientation.

(i) Rights of Shareholders

While shareholders of banks enjoy the same rights as other shareholders, in view of the

importance of having "fit and proper" management, transfers of shares beyond a threshold require acknowledgement of the RBI in addition to compliance with other laws. One of the basic requirements is that persons who control and manage the business of a bank must be men of integrity, above board, trustworthy and must possess appropriate skills and experience. Similarly in the case of the new private sector banks, the promoters are required to retain their share of 40 per cent for five years in order to ensure that they have a long-term interest in the financial viability of the bank. To limit the control, which any one group can have over the operations of the banks, no person can exercise voting rights in excess of 10 per cent in private sector banks. At the same time, widely held majority shareholding provides the needed checks and balances in the form of an elected board and control by general body in matters of structural nature.

(ii) Role of Stakeholders

Different laws cover the rights of the stakeholders in banking companies -depositors, creditors and employees and these laws are respected and enforced. Banks also owe a duty to the communities and their activities should be in public interest. The disclosure and transparency measures ensure that all stakeholders have the necessary information that they require.

(iii) Disclosure and transparency

Disclosure and transparency are key pillars of a corporate governance framework because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of. We see transparency and disclosure as an important adjunct to the supervisory process as they facilitate market discipline of the banks. The task of moving towards greater disclosure in India was taken up in 1992 when the formats of the financial statements were revised and enlarged. Since the liberalisation measures introduced in the beginning of this decade, the extent of disclosure has been enhanced gradually with the process accelerating in the last couple of years. The banks have now to disclose all significant data such as Capital (Tier I and Tier II), capital adequacy ratio, percentage of net Non-performing Advances (NPAs) to net advances, provisions towards NPAs and investments, critical operating ratios like interest, non-interest income and operating profit to working funds and return on assets. From March 2000, banks will have to disclose, among others, maturity pattern of assets/liabilities, foreign currency assets and liabilities, movements in NPAs and associated provisions and lending exposure to sensitive sectors as may be announced from time to time. With these the disclosure standards in India would generally be on par with international standards.

In order to provide easy access to the disclosed capital, asset quality and performance indicators, data for individual bank and the banking system as a whole are published by the Reserve Bank of India in its annual 'Report on Trend and Progress of Banking in India'.

(iv) Responsibilities of the Board

The governance of banks rests with the board of directors. For this reason much of the

debate has been focussed on the structure and composition of the board, the board procedures and the responsibility of the board. In the light of deregulation in interest rates and the greater autonomy given to banks in almost all operational matters, the role of boards of directors of even the public sector banks have become more significant. The Board should ensure that the bank is run with integrity, complies with all legal requirements and regulatory standards and conducts its business in accordance with high ethical standards. Boards have been required to lay down policies in critical area such as investments, loans, asset-liability management and management and recovery of NPAs. They have to ensure that proper control systems exist and are functioning and that the operations of bank are conducted with due regard to prudence including the assurance that necessary provision are made and all statutory and other directives are complied with. The RBI has also directed the banks to set up Audit Committees of the Board. The Audit Committee is charged with the responsibility of ensuring the efficacy of the entire internal control and audit functions in the bank besides compliance with the Inspection reports of the RBI, internal and concurrent auditors. To ensure both professionalism and independence of these committees, Chartered Accountant directors on the board of banks are mandatory members and Chairman is not to be part of the Audit Committee. The RBI through various measures has emphasised the primacy of the Board of Directors and its essential role as the instrument of corporate governance in the affairs of the bank. The laws also prohibit connected lending i.e., lending to companies in which directors are interested. Lending to a bank's own subsidiaries and affiliates are also subject to prudential limits and has to be undertaken at market rates.

Recently, the RBI has introduced rating on the banks as part of the CAMELS supervisory process. This takes into account the working and the effectiveness of the Board and its committees including the Audit committee, effectiveness of the management in ensuring regulatory compliance and adequacy of control exercised by the Head/Controlling offices besides ensuring asset quality and profitability.

Narasimham Committee has recommended that the RBI Nominees from the boards of banks should be withdrawn, as it is perceived to be in conflict with the RBI's regulatory and supervisory role. In fact, the RBI has been withdrawing its nominees from the boards of well managed old private banks.

Non-banking finance companies and DFIs

Although these companies may not be like banks, being financial intermediaries and an important part of the financial system they are also subject to similar prudential regulations. Certain other regulations have been prescribed by RBI which are specific to the sector.

Corporate governance and the role of Banks and DFIs

Banks and development financial institutions in India particularly DFIs have an important

role in the governance of companies where they have their nominee directors. The role of these nominee directors is to protect the interest of the institution and also as a member of the Board be responsible as any other director. However in certain instances where irregularities have been detected, the role of nominee directors has attracted attention. It is felt in general that these nominee directors have a duty to act in the larger public interest. No doubt the issue of nominee directors of term-lending institutions and mutual funds has become a contentious issue.

Objectives of corporate governance in banks/financial companies

There is lot of focus on raising the level of corporate governance in India mainly from the angle of creating shareholder value and also being more transparent in the operations. In India, particularly if privatisation has to succeed, it becomes imperative that the institutions in the private sector which manage public savings act with integrity and responsibility and adopt sound business practices. We have come across certain cases in the non-bank financial sector where the directors have defrauded the depositors. This can affect the confidence of depositors and leads to public mistrust. If companies have to attract local and foreign capital, they have to demonstrate better standards of governance. In this context, I would like to emphasise that in banks and other financial sector companies, financial soundness and viability of the bank should come first. Once this is assured, the shareholder value will not only be retained but enhanced.

Issues relating to corporate governance

(i) It is recognised that independence is the cornerstone of accountability and that independent boards are essential to a sound governance structure. In India in most banks the CEO and Chairman's positions is combined. There has been much debate concerning the wisdom and feasibility of an independent chairman. The Cadbury Committee had stated that there should be a clearly accepted division of responsibilities at the head of a company which will ensure a balance of power and authority such that no one individual has unfettered powers of decision. 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 US Corporate Governance Core Principles has also addressed this issue. It states that a substantial majority of the board should consist of directors who are independent. Where the CEO also chairs the Board he is clearly more powerful than the Board. It has therefore suggested that when the chair of the board also serves as the company's CEO the board designates -formally or informally, an independent director who acts in a lead capacity to co-ordinate the other independent directors. In a discussion paper brought out by Shri S.H. Khan, Chairman, NSE and former Chairman IDBI on Corporate Governance of Financial Institutions, this issue has been raised. According to him "to avoid the concentration of power in the hands of a single individual and, in recognition of the pivotal role of the Chairman in securing good corporate governance, it is important that the roles of the Chairman and of the Chief Executive Officer be separated and different individuals appointed to the positions. The Chairman should ideally be a non-executive director of the institution." In India too we need to examine how to ensure balance of power and authority where the roles of CEO and Chairman are combined at the same time not confusing accountability or disrupting daily operations. Certain board committees should also consist entirely of independent directors. The feasibility of compensation pattern in banks in the

form of cash and stock may also become relevant in future.

(ii) One of the principles of sound banking regulation is that "connected lending" should not be permitted i.e., lending by banks to directors or companies in which directors are interested. The Banking Regulation Act does not permit such lending. A similar provision/regulation does not apply to financial institutions (FIs) and it is possible for directors on the board of FIs to continue to enjoy borrowing facilities from the FIs. This needs to be reviewed.

(iii) The other issue relates to the number of non-executive directors. In public sector banks we have currently two whole time directors including CEO and the rest are non-executive directors and nominee directors. Employee directors are also on the board. A suggestion has been made that the number of executive directors should be increased. The Cadbury Committee has suggested that the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. The Khan discussion paper has recommended that independent non executive directors should constitute a majority on the board. Ordinarily, not less than two third of the total strength of the board should be non executive directors. To ensure that they bring an independent judgement to bear on issues of strategy, performance and standards of conduct, he has suggested that a majority of the non executive directors should be independent of the institution as well as of the Government. To ensure balance in the composition of the board, it is necessary that at least three or four directors not exceeding one third of the total strength, be executive directors. It will be useful to have the views on these issues from the participants.

(iv) Recently, the Monetary Authority of Singapore (MAS) issued a statement on measures to strengthen the banking system. One of the measures relating to corporate governance is to require all local banks to form Nominating Committees within the Boards. The Nominating Committee will comprise five members of the Board where appointments will be made by the board subject to MAS approval. The purpose of the Committee is to ensure that only the most competent individuals are appointed to the board and key management position. In India a major challenge is to professionalise Board of Directors.

To conclude, the new strategy of supervision recognises strong corporate governance function supported by competent (executive) management as the first line of defence in supervision of banks and financial institutions. The Reserve Bank of India has appointed the following Working Groups in order to bring about systemic improvements in the financial sector:

(1) In the light of the Narasimham Committee recommendations relating to urban banks, the RBI has appointed a working group to evolve objective criteria, to determine the need and potential for organising urban cooperative banks, review the existing entry point norms and the existing policy pertaining to branch licensing and area of operation of urban cooperative banks, to consider measures for determining the future set up of weak/unlicensed banks and to examine the feasibility of introducing capital adequacy norms for urban cooperative banks and to suggest necessary legislative amendmends to BR Act and Co-operative Societies Act of various states for strengthening the urban banking movement.

(2) Reserve Bank of India has decided to undertake a study of the existing system of Deposit Insurance in India and of the need for certain reforms therein as a crucial component of the financial sector reforms which are being implemented. It has accordingly set up a high powered Advisory Group.

(3) It is proposed to establish a credit information bureau for the collection of credit information relating to borrowers and providing such information to the financial system with a view to facilitating better credit risk Management.