Report of The Committee to Review Governance of Boards of Banks in India

May 2014

Letter of Transmittal

12 May 2014

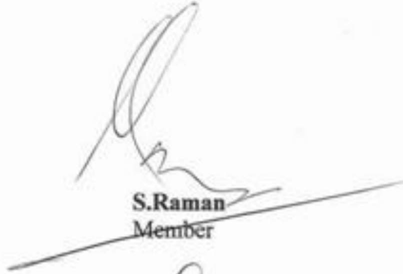
Dr. Raghuram G. Rajan
Governor
Reserve Bank of India
Mumbai

Dear Sir,

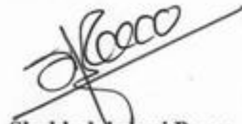
We hereby submit the Report of the Committee to Review the Governance of Boards of Banks in India.

Yours sincerely,

P.J.Nayak
Chairman

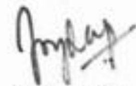


S.Raman
Member

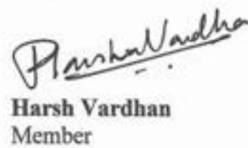


Shubhalakshmi Panse
Member

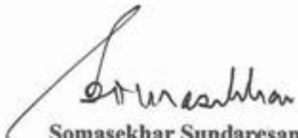
Pratip Kar
Member



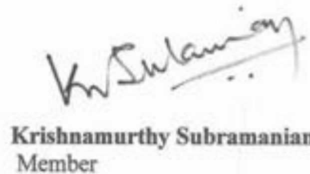
Joydeep Sengupta
Member



Harsh Vardhan
Member



Somasekhar Sundaresan
Member



Krishnamurthy Subramanian
Member

Encl: As above

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Committee Members and Terms of Reference

The Committee to Review Governance of Boards of Banks in India was constituted by the RBI Governor on 20th January, 2014. The Committee was expected to submit its report within three months from the date of its first meeting. The Committee held five meetings, commencing 18th February, 2014.

Committee Members:
Chairman:
P.J. Nayak: Former Chairman and CEO, Axis Bank, and Former Country Head, Morgan Stanley India, Mumbai

Members:
S. Raman: Whole Time Member, SEBI, Mumbai
Shubhalakshmi Panse: Chairperson & Managing Director, Allahabad Bank, Kolkata (since retired)
Pratip Kar: Former Executive Director, SEBI, Mumbai
Joydeep Sengupta: Director and Senior Partner, McKinsey and Company
Harsh Vardhan: Partner, Bain & Company, Mumbai
Somasekhar Sundaresan: Partner, J. Sagar Associates, Mumbai
Krishnamurthy Subramanian: Assistant Professor, Indian School of Business, Hyderabad

Terms of Reference:
1. To review the regulatory compliance requirements of banks' boards in India, to judge what can be rationalised and where requirements need to be enhanced.
2. To examine the working of banks' boards including whether adequate time is devoted to issues of strategy, growth, governance and risk management.
3. To review central bank regulatory guidelines on bank ownership, ownership concentration and representation in the board.
4. To analyse the representation on bank boards to see whether the boards have the appropriate mix of capabilities and the necessary independence to govern the institution, and to investigate possible conflicts of interest in board representation, including among owner representatives and regulators. In this regard, to also assess and review the 'fit and proper' criteria, for all categories of directors of banks, including tenor of directorship.
5. To examine board compensation guidelines.
6. Any other issue relevant to the functioning of the banks' boards and the governance they exercise.

Acknowledgements

The Committee has benefited from the multiple perspectives shared by several people knowledgeable about India's banks and issues in board governance.

The Committee expresses its gratitude to the RBI Governor, Raghuram Rajan, for his initiative in seeking a focus on the governance of bank boards. It would also like to thank K.C. Chakrabarty and R. Gandhi, Deputy Governors, and B. Mahapatra, Executive Director, DBOD, for raising several issues in the functioning of banks which cause regulatory concern.

The Committee met with K.R Kamath, A.K. Khandelwal, T.T. Ram Mohan, S.S. Mundra, Aditya Puri, Shyam Srinivasan and M.S. Sriram. It is grateful to them for alerting the Committee to several governance issues which boards of banks presently face.

Informal discussions and helpful references assisted in nuancing the Committee's ideas and brought greater precision to its thinking. It would like particularly to thank Vinay Baijal, B. Gopalakrishnan, Shyamala Gopinath, Ishaat Hussain, Hemant Kaul, Sunder Korivi, Bapi Munshi, Francis Rozario, S. Santhanakrishnan, Pritam Singh, Anand Sinha, H.N. Sinor, Amit Tandon, Mohan Tanksale, Renny Thomas, Usha Thorat and K.J. Udeshi.

The Committee expresses its gratitude to the Indian School of Business, Hyderabad, for enabling a Research Group there to work with and assist the Committee's empirical work, and to Samanvaya Agarwal, Prasanna Tantri, Saipriya Kamath, Arkodipta Sarkar and many others in ISB for their active support; to Manu Balakrishnan from McKinsey & Company for details of international regulation; and to Abishek Venkataraman from J. Sagar Associates for assistance on legal matters; as also to Bain & Company and J. Sagar Associates for the use of their Mumbai offices for the Committee's deliberations. The Committee would also like to thank CMIE for the use of its corporate database, Prowess; and ICRA, for sharing its data on banks.

The Committee received written representations, for which it is grateful, from AGB & Partners, Axis Bank, Protima Lokhandwala, Mukesh Mohan, B. Yerram Raju and Kaushal Sharma.

Finally, the smooth functioning of the Committee owes greatly to the excellent support, including in the compilation of large volumes of bank data, from RBI. The Committee would like to express its gratitude to Thomas Mathew, General Manager, DBOD, who provided the coordinational interface between RBI and the Committee, and to Prodosh Ganguly, V.K. Jain, A.Y. Korde and D.B. Piprodia for their active assistance.

List of Acronyms

ABI	Authorised Bank Investor
ACC	Appointments Committee of the Cabinet
ALM	Asset Liability Management
ATM	Automated Teller Machine
BBB	Bank Boards Bureau
BIC	Bank Investment Company
CA	Chartered Accountant
CASA	Current Accounts and Saving Accounts
CBI	Central Bureau of Investigation
CEO	Chief Executive Officer
CMD	Chairman and Managing Director
CVC	Central Vigilance Commission
LIC	Life Insurance Corporation of India
NOFHC	Non-Operative Financial Holding Company
NPA	Non-Performing Asset
RBI	Reserve Bank of India
RoA	Return on Assets
RTI	Right to Information
SARFAESI	Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
IDBI	Industrial Development Bank of India
SBI	State Bank of India
SEBI	Securities and Exchange Board of India
SUUTI	Special Undertaking of the Unit Trust of India
UK	United Kingdom
US	United States
UKFI	UK Financial Investments Ltd
UTI	Unit Trust of India

Chapter 1

Overview of the Report and List of Recommendations

1.1 Overview of the Report

Several perspectives have guided the approach and recommendations of this Report:

1. The financial position of public sector banks is fragile, partly masked by regulatory forbearance. Forbearance delays, but does not extinguish, the recognition of this fragility. Capital is significantly eroded with the proportion of stressed assets rising rapidly. The Report projects, under different scenarios, the capital requirements till March 2018 in order that provisions are prudent, there is adequate balance sheet growth to support the needs of the economy, and capital is in line with the more demanding requirements of Basel 3.

2. It is unclear that the boards of most of these banks have the required sense of purpose, in terms of their focus on business strategy and risk management, in being able to provide oversight to steer the banks through their present difficult position. The boards are disempowered, and the selection process for directors is increasingly compromised. Board governance is consequently weak.

3. The onus of remedying this situation through radical reform lies primarily with the Central Government. In the absence of such reform, or if reform is piecemeal and non-substantive, it is unlikely that there will be material improvement in the governance of these banks. This could impede the Government's objective of fiscal consolidation. The fiscal cost of inadequate reform will therefore be steep.

4. The high leverage that banks operate under makes banking a riskier commercial activity than most non-financial businesses. Unless banks are extremely well run and with a strong focus on financial returns, they tend to falter. The Central Government is a good example of a bank shareholder which has suffered deeply negative returns over decades. It is therefore in the Government's own interest to provide clarity in the objectives set for bank boards, and to thereby improve governance and management.

5. The Report proposes that the Government distances itself from several bank governance functions which it presently discharges. For this purpose it recommends that the Bank Nationalisation Acts of 1970 and 1980, together with the SBI Act and the SBI (Subsidiary Banks) Act, be repealed, all banks be incorporated under the Companies Act, and a Bank Investment

Company (BIC) be constituted to which the Government transfers its holdings in banks. The Government's powers in relation to the governance of banks should also be transferred to BIC.

6. The process of board appointments, including appointments of whole-time directors, needs to be professionalised and a three-phase process is envisaged. In the first phase, until BIC becomes operational, a Bank Boards Bureau (BBB) comprising former senior bankers should advise on all board appointments, including those of Chairmen and Executive Directors. In the second phase this function would be undertaken by BIC, which would also actively strive to professionalise bank boards. In the third phase BIC would move several of its powers to the bank boards. The duration of this three-phase transition is expected to be between two and three years.

7. Governance difficulties in public sector banks arise from several externally imposed constraints. These include dual regulation, by the Finance Ministry in addition to RBI; board constitution, wherein it is difficult to categorise any director as independent; significant and widening compensation differences with private sector banks, leading to the erosion of specialist skills; external vigilance enforcement though the CVC and CBI; and limited applicability of the RTI Act. A more level playing field with private sector banks is desirable.

8. If the Government stake in these banks were to reduce to less than 50 per cent, together with certain other executive measures taken, all these external constraints would disappear. This would be a beneficial trade-off for the Government because it would continue to be the dominant shareholder and, without its control in banks diminishing, it would create the conditions for its banks to compete more successfully. It is a fundamental irony that presently the Government disadvantages the very banks it has invested in.

9. The Report proposes the need for wide-ranging human resource policy changes. These would encompass getting younger people into top management, for which a demographic opportunity has now arisen, and which would thereby lead to longer tenures; and succession planning. There is also a need to envision afresh the process of countering corruption through a redesign of the existing process of vigilance enforcement. The Report argues that present modalities are damaging and erode the ability of the banks to compete strategically, besides being only weakly effective in combating corruption.

10. Governance issues in private sector banks originate from an altogether different set of concerns. There are issues which arise from ownership constraints stipulated by RBI, which could misalign the interests of shareholders with those of the management. In several other jurisdictions, these constraints are less rigid. Rigidity keeps out certain kinds of investors and thereby reduces the pool of capital that banks could otherwise attract. When individual shareholdings are small, investors also tend to be more disengaged. Allowing larger block shareholders generally enhances governance.

11. In order to permit certain kinds of investors to take larger stakes, it is proposed that a category of Authorised Bank Investors (ABIs) be created, comprising all diversified funds which are discretionally managed by fund managers and which are deemed fit and proper. It is proposed that an ABI be permitted a 20 per cent equity stake without regulatory approval, or 15 per cent if it also has a seat on the bank board. All other financial investors should be permitted upto 10 per cent.

12. The shareholding permitted to promoters of banks is also tightly structured at present. Under the 2013 RBI guidelines, while such investors could begin with large stakes in banks, after some years they would need to reduce their stake and eventually can own no more than 15 per cent. The Report proposes increasing the continual stake ceiling to 25 per cent. It also proposes that for distressed banks, private equity funds - including sovereign wealth funds - be permitted to take a controlling stake of upto 40 per cent.

13. The Report also proposes that the principle of proportionate voting rights should constitute part of the regulatory bedrock that fosters good governance.

14. It is also necessary for boards to be vigilant about the quality of the loan asset portfolios as these sensitively affect the integrity of financial reporting. In private sector banks senior management is incentivised on the basis of bank profitability, and the compensation paid out - through stock options - is in substantial measure contingent on the stock price of the bank. There is a potential incentive to evergreen assets in order that provisions do not make a dent in profitability.

15. With RBI also having moved away from detailed to risk-based supervision, the annual financial inspections investigate the asset quality reporting accuracy of banks less rigorously. It appears desirable therefore that RBI conducts random and detailed checks on asset quality in these banks.

16. Wherever significant evergreening in a bank is detected by RBI, it is recommended that penalties be levied through cancellations of unvested stock options and claw-back of monetary bonuses on officers concerned and on all whole-time directors, and that the Chairman of the audit committee be asked to step down from the board.

17. Boards should also define for third-party products what constitutes proper selling practices. Products need to be matched with customer demographics, customer income and wealth, and customer risk-appetite.

18. Profit-based commissions for non-executive directors should be permitted in, but not before, Phase 3 of the transition process described in Observation 6 above.

19. Old private sector banks typically began as community banks, although some have attempted to outgrow their historical origins and imitate the new private sector banks, bringing in diversified boards and broadbasing senior management. However, many other banks have management styles where the community hold remains intact, either tacit or explicit. The designation of a 'promoter director' then develops, who controls shareholder voting, the board and the employees. The CEO thereby becomes disempowered. RBI should attempt to diversify boards in banks where independence is not visible, by mandating prior RBI approval for directors in such banks. RBI should also mandate a separation between board oversight and executive autonomy.

20. The Report also proposes details of legislation needed in order to implement its Recommendations.

1.2 List of Recommendations

Recommendation 2.1: Given the lower productivity, steep erosion in asset quality and demonstrated uncompetitiveness of public sector banks over varying time periods (as evidenced by inferior financial parameters, accelerating stressed assets and declining market share), the recapitalisation of these banks will impose significant fiscal costs. If the governance of these banks continues as at present, this will impede fiscal consolidation, affect fiscal stability and eventually impinge on the Government's solvency. Consequently, the Government has two options: either to privatise these banks and allow their future solvency to be subject to market competition, including through mergers; or to design a radically new governance structure for these banks which would better ensure their ability to compete successfully, in order that repeated claims for capital support from the Government, unconnected with market returns, are avoided.

Recommendation 2.2: There are several external constraints imposed upon public sector banks which are inapplicable to their private sector competitors. These constraints encompass dual regulation (by the Finance Ministry, and by the RBI, which goes substantially beyond the discharge of a principal shareholder function); the manner of appointment of directors to boards; the short average tenures of Chairmen and Executive Directors; compensation constraints; external vigilance enforcement; and applicability of the Right to Information Act. Each of these constraints disadvantages these banks in their ability to compete with their private sector competitors. The Government and RBI need to move to rapidly eliminate or significantly reduce these constraints, in the absence of which managements of public sector banks will continue to face an erosion of competitiveness. Further, it is only after these external

constraints have been addressed would it be practicable for public sector banks to address a host of internal weaknesses which affect their competitiveness.

Recommendation 3.1: There is a need to upgrade the quality of board deliberation in public sector banks to provide greater strategic focus. There are seven themes which appear critical to their medium-term strengths comprising Business Strategy, Financial Reports and their Integrity, Risk, Compliance, Customer Protection, Financial Inclusion and Human Resources. All other items for discussion should be brought to the Boards by exception and should typically be discussed in committees of boards. Among the seven themes identified for detailed board scrutiny, a predominant emphasis needs to be provided to Business Strategy and Risk.

Recommendation 3.2: As the quality of board deliberation across firms is sensitive to the skills and independence of board members, it is imperative to upgrade these skills in boards of public sector banks by reconfiguring the entire appointments process for boards. Otherwise it is unlikely that these boards will be empowered and effective. Specific recommendations for this purpose are separately made in this report.

Recommendation 3.3**:** The Calendar of Reviews needs either to be revoked, or else to be freshly designed so as to ensure that the time of the board is spent largely on the seven critical themes listed in Recommendation 3.1, with specific attention given to business strategy and risk management.

Recommendation 4.1: The Government needs to move rapidly towards establishing fully empowered boards in public sector banks, solely entrusted with the governance and oversight of the management of the banks. The transition path for this is contained in separate Recommendations.

Recommendation 4.2: The Government should set up a Bank Investment Company (BIC) to hold equity stakes in banks which are presently held by the Government. BIC should be incorporated under the Companies Act, necessitating the repeal of statutes under which these banks are constituted, and the transfer of powers from the Government to BIC through a suitable shareholder agreement and relevant memorandum and articles of association.

Recommendation 4.3: While the Bank Investment Company (BIC) would be constituted as a core investment company under RBI registration and regulation, the character of its business would make it resemble a passive sovereign wealth fund for the Government's banks. The Government and BIC should sign a shareholder agreement which assures BIC of its autonomy and sets its objective in terms of financial returns from the banks it controls. It is also vital that the CEO of BIC is a professional banker or a private equity investment professional who has substantial experience of working in financial environments where investment return is the yardstick of performance, and who is appointed through a search process. While the non-

executive Chairman and CEO of BIC would be nominated by the Government, it is highly desirable that all other directors be independent and bring in the requisite banking or investment skills.

Recommendation 4.4: The CEO of the Bank Investment Company (BIC) would be tasked with putting together the BIC staff team. BIC employees would be incentivised based on the financial returns that the banks deliver. If such incentivisation requires the Government to hold less than 50 per cent of equity in BIC, the Government should consider doing so, as it will be the prime financial beneficiary of BIC's success.

Recommendation 4.5: The Government should cease to issue any regulatory instructions applicable only to public sector banks, as dual regulation is discriminatory. RBI should be the sole regulator for banks, with regulations continuing to be uniformly applicable to all commercial banks.

Recommendation 4.6: The Government should also cease to issue instructions to public sector banks in pursuit of development objectives. Any such instructions should, after consultation with RBI, be issued by that regulator and be applicable to all banks.

Recommendation 4.7: The transfer of the Government holding in banks to the Bank Investment Company (BIC), and the transitioning of powers to bank boards with the intent of fully empowering them, needs to be implemented in phases. The following three-phase transition is recommended:

Phase 1: (a) Legislative amendments enacted to repeal the Acts through which public sector banks have been constituted as statutory bodies, the incorporation of these banks under the Companies Act, and the transfer of their ownership to BIC, with Government initially holding the entire equity in BIC.

(b) A professional board constituted for BIC.

(c) All existing ownership functions in relation to banks transferred from the Government to BIC.

(d) All non-ownership functions, whether of a regulatory or development nature, transferred from the Government to RBI.

(e) BIC commences the process of professionalising and empowering bank boards.

(f) Ownership functions taken over by BIC from the Government.

Phase 2: (g) The reconstitution of bank boards coordinated by BIC.

(h) Bank ownership functions continued to be executed by BIC.

Phase 3: (i) All ownership functions transferred by BIC to the bank boards. The appointments of independent bank directors and whole-time directors (including the CEO) become the responsibility of bank boards.

(j) BIC ensures that each bank splits the position of the bank's Chairman into a non-executive Chairman (nominated by BIC) and a CEO (nominated by the board).

(k) Strict compliance ensured with Clause 49 of SEBI's Listing Guidelines, which stipulates a minimum number of independent directors. The Chairman, CEO, other wholetime directors and BIC's nominee directors, would constitute the 'inside directors', those connected to the bank's principal shareholder (viz. the Government). All other board members would be 'outside directors', and therefore be characterised as independent.

(l) A lead independent director would be nominated for each bank board by the set of independent directors. BIC would define the role of such directors.

(m) BIC ceases to exercise ownership functions, and morphs instead into exercising investor functions.

(n) Consequently, BIC is tasked with the responsibility of protecting the Government's financial investment in the banks, by raising the financial returns to the Government.

Recommendation 4.8: It would be desirable for the bank licensing regime to move to a uniform license across all broad-based banks, irrespective of ownership, subject to inter-jurisdictional reciprocity considerations in respect of foreign banks, and niche licenses for banks with more narrowly defined businesses.

Recommendation 4.9: Other than the Government's own stake, which would be unconstrained, all other investment limits recommended in Chapter 6 for different categories of investors in private sector banks should also be applicable to investors in public sector banks.

Recommendation 4.10: It is desirable for the Government to level the playing field for public sector banks in relation to their private sector competitors. Reducing the proposed Bank Investment Company's investment in a bank to less than 50 per cent will free the bank from external vigilance emanating from the Central Vigilance Commission, from the Right to Information Act, and from Government constraints on employee compensation. The trade-off is worth grasping, as more competitive public sector banks will enhance financial returns to the Government with no effective dilution of control. In terms of the transition mechanism

proposed, this would be part of Phase 3, and add a 15th step to the 14 steps listed in Recommendation 4.7, as follows:

> (o) The Government should consider reducing its holding in banks to less than 50 per cent, in order that there is a restoration of a level playing field for public sector banks in matters of vigilance enforcement, employee compensation and the applicability of the right to information. Vigilance enforcement and compensation policy will thereafter be the responsibility of bank boards.

Recommendation 5.1: In the context of the three-phase process earlier proposed, it would be desirable to entrust the selection of the top management of public sector banks during Phase 1 to a newly constituted Bank Boards Bureau (BBB). It is recommended that BBB be set up by an executive order of the Government and comprise three senior bankers chosen from among those who are either serving or retired Chairmen of banks, one of whom will be the Chairman of BBB. They would be bankers of high standing and the Government should select them in consultation with RBI. Where selections to top bank managements are proposed by BBB but not accepted by the Government, BBB will make a public disclosure.

Recommendation 5.2: The Chairman and each member of BBB should be given a maximum tenure of three years. During this period the transfer of powers to the Bank Investment Company (BIC) is envisaged and upon transfer to the BIC, tenure would cease. There will be no renewal of their contract thereby ensuring that BBB's autonomy and independence is not compromised. Their remuneration would be at least that of existing public sector bank Chairmen.

Recommendation 5.3: It is desirable to ensure a minimum five-year tenure for bank Chairmen and a minimum three year tenure for Executive Directors. Given the very large retirements in senior management positions expected in the next three years, well-designed personnel policies to identify talented people who have demonstrated success would enable them to be groomed for senior management. This could alter the demographic profile of top management with beneficial consequences. With younger people of talent and successful track record in top management, the minimum tenures would get automatically ensured.

Recommendation 5.4: Cases of vigilance enforcement against wholetime directors and other bank employees for decisions taken by them must be based on evidence that the director or employee personally made a wrongful gain. For levelling criminal charges, fraud must manifest itself through evidence of self-benefit. In loan and expenditure cases, deviations from procedure must not constitute the sole basis for initiating criminal action.

Recommendation 5.5: It is feasible and vital that in Phases 1-3 the selection process is initiated in good time to complete the appointments approval before the expiry of tenures of the

incumbents. Delays presently occur because of vigilance clearance. It is recommended that this clearance be conducted only at the stage when candidates are short-listed, and not resumed after the Selection Committee recommends the candidate for appointment.

Recommendation 5.6: During Phase 1 of the three-stage empowerment of bank boards proposed in Chapter 4, the selection of non-official directors should be entrusted to the Bank Boards Bureau.

Recommendation 5.7: It is proposed that, from the second phase, the maximum term for any director other than whole-time directors be restricted to seven years. Further, after any tenure on a bank board, there would be a cooling-off period of five years, for the director to return to the same bank board, and a two-year cooling-off period for the director to be appointed on the board of any other bank.

Recommendation 5.8: Any director on the board of a public sector bank will be eligible to be a director on the boards of at most six other listed companies.

Recommendation 5.9: A partner or employee of a firm auditing a bank would be conflicted in becoming a director in another bank, in view of the client information which auditors have access to. Likewise, for such partner or employee to be a director in the same bank being audited would violate auditor independence. Therefore, no such partner or employee should be a director on the board of any bank.

Recommendation 5.10: RBI directors should step down from bank boards during Phase 3 of the transition process, unless a bank is troubled or raises special concerns.

Recommendation 5.11: The positions of bank Chairman and CEO should be separated during Phase 3 of the transition process.

Recommendation 6.1: RBI should designate a specific category of investors in banks as Authorised Bank Investors (ABIs), defined to include all funds with diversified investors which are discretionally managed by fund managers and are deemed to be fit and proper. ABIs would therefore include pension funds, provident funds, long-only mutual funds, long-short hedge funds, exchange-traded funds and private equity funds (including sovereign wealth funds) provided they are diversified, discretionally managed and found to be 'fit and proper'. ABIs would exclude all proprietary funds (including those which are hedge funds or set up by corporates), non-banking finance companies and insurance companies.

Recommendation 6.2: A single ABI should be permitted a maximum 20 per cent investment stake in a bank without regulatory approval provided it possesses no right to appoint a board director. An ABI which is given board representation, and thereby exercises a measure of influence, should be permitted a lower 15 per cent maximum investment limit without

regulatory approval. Every other investor should be permitted no more than 10 per cent without regulatory approval.

Recommendation 6.3: It would be impractical for either RBI or a bank to conduct a prior scrutiny on whether an investor is 'fit and proper' before an investment occurs. If, however, at any stage and based on information laid before it, RBI concludes that an investor in a bank is not fit and proper, RBI would be entitled to freeze the investor's voting rights in the bank and to seek its disinvestment within a specified time period. As the initial onus of belief in being fit and proper therefore falls on the investor, RBI should also consider offering an informal guidance service on whether past regulatory or other action against an investor would disqualify categorisation as fit and proper.

Recommendation 6.4: For promoter investors other than ABIs it is proposed that the continual stake ceiling be raised to 25 per cent.

Recommendation 6.5: It would be inappropriate for regulation to stipulate a period within which banks should be listed, particularly from a governance perspective, as premature listing could be injurious to minority shareholder interests. It would therefore be desirable to modify the 2013 guidelines for new private sector banks accordingly.

Recommendation 6.6: For banks identified by RBI as distressed, it is proposed that private equity funds, including sovereign wealth funds, be permitted to take a controlling stake of upto 40 per cent.

Recommendation 6.7: The principle of proportionate voting rights should constitute part of the regulatory bedrock which fosters good bank governance, as it aligns investors' powers in shareholder meetings with the size of their shareholding. It is therefore desirable for RBI to raise the limit for voting rights to 26 per cent, in accordance with legislative changes recently enacted. It is also desirable to further amend legislation to remove all constraints on voting rights in order to align it with company law.

Recommendation 6.8: Where the principal shareholder in an entrepreneur-led bank is also the bank's CEO, RBI should satisfy itself that the board is adequately diversified and independent, with professionals of high standing. Where RBI lacks confidence of such independence, the controlling shareholder should be asked to step down as CEO.

Recommendation 7.1: Wherever significant evergreening in a bank is detected by RBI, it is recommended that RBI imposes penalties wherein:

1. Unvested stock options granted to officers who have indulged in the practice, and to all whole-time directors, be cancelled in part or in full.

2. Monetary bonuses paid to such officers and to all whole-time directors, be clawed back by the bank, in part or in full.

3. The Chairman of the audit committee be asked to step down from the board.

Recommendation 7.2: As the stance of RBI supervision has now moved from detailed to risk-based supervision, it is desirable for supervisors to conduct random detailed checks on the reported quality of banks' asset portfolio, particularly in those banks where compensation through stock options is liberally provided.

Recommendation 7.3: Boards of all banks, and particularly of the new private sector banks because of their dominant market share, need to provide oversight on customer protection in the distribution of third-party products, including matching the positioning of these products with customer demographics, customer income and wealth, and customer risk-appetite; and ensuring that product features are clearly explained to the customer.

Recommendation 7.4: Profit-based commissions for non-executive directors should be permitted in, but not before, Phase 3 of the transition mechanism proposed in Chapter 4.

Recommendation 7.5: The minimum and maximum age prescribed by the Companies Act at the time of appointment should be applicable to all directors of private sector banks. For whole-time directors, the maximum age should be 65.

Recommendation 7.6: For old private sector banks where RBI has doubts about whether boards are adequately independent of the controlling shareholders of the banks, RBI should mandate that all director appointments be made with the prior approval of RBI. It should be RBI's endeavour to ensure adequate director independence in the board.

Recommendation 7.7: In old private sector banks where RBI has doubts about whether the CEO has full control over the executive management of the bank, it should examine the precise areas of intervention by directors in bank committees and outside of it, and mandate a separation between board oversight and executive autonomy.

Chapter 2

The Changing Market Structure in Indian Banking

2.1 The Weakening of Public Sector Banks

There are several ways in which a narrative of the transformation in Indian Banking can be told. If a long telescopic view of the past is taken, encompassing the last two decades, the emergence of new banks in the private sector assumes focus, with their reliance on new technologies for handling systems and individual products, and accompanied by the rise of new business models, particularly in the distribution of banking products. If a more recent view of the last decade is instead adopted, during much of which the Indian economy grew strongly, the banks achieved strong balance sheet growth, though of variable asset quality, in an environment where public markets generally responded positively to the requirements of bank capital. If a more recent three year characterisation of India's banks is instead sought, coinciding with decelerating growth in the economy and the dangerously high leverage taken by some asset-heavy corporate businesses, the burgeoning stress in the balance sheets of most banks and the consequent deterioration in the capital supporting their businesses becomes a major area of concern.

Each of these narratives points to a common theme: the weakening of public sector banks. They have lower profitability and productivity ratios than their private sector competitors, they have lost significant market share, and their asset quality is much weaker, in some cases worsening to grave proportions. More alarmingly, several projections for the future made by research analysts who study Indian banks, suggest that the pain could worsen in the next few years, necessitating a large recapitalisation of the public sector banks. These levels of recapitalisation will prove challenging to any Government which strives to achieve fiscal consolidation, and it is therefore in the Government's own interest to overhaul the manner in which these banks are governed and managed.

Every industry witnesses market structure changes over long years, and such changes are a consequence of differences in productivity often triggered by disruptive technologies or product differentiation, and therefore part of the Schumpeterian 'creative destruction' which enhances efficiency. In the case of India's banks, however, the dominant variable determining market structure changes appears to be Government ownership. This too could be a matter on

which an external observer could arguably have remained agnostic, were the banking sector not intimately connected with the macro-economy. The major share of financial savings is intermediated through the public sector banks, which have been the dominant providers of loan finance for infrastructure creation and manufacturing. These banks are too large, too connected and too complex for a further weakening of their balance sheets to be contemplated with equanimity. And central to preventing this is the quality of board governance. Are there other models we can learn from which would improve governance? Are boards of these banks spending adequate time on business strategy and risk mitigation? They would also need to resist politically-induced lending and to repair the compromised integrity of the credit business. Do bank boards have the relevant domain skills, strategic competence and independent thinking which well-run organisations constantly strive for? Does the relationship between the Government and its banks need to be thought afresh?

In this Chapter we attempt a diagnostic on how the public sector banks have weakened, and provide pointers to how they might continue to worsen unless there is an overhaul of their governance. If we are to continue to have a pivotal public sector banking system, it had better be managed efficiently, for the alternative - risking financial instability - would be much too unpleasant to contemplate and eventually to manage. The boards of these banks would then need to focus more sensitively and granularly on bank strategy and risk mitigation, devote more attention to business development and compliance, and be alert to the manner in which issues of customer protection and financial inclusion might impact the style of running the banks. They would need to be conscious of the depletion of human capital, likely to worsen in the years ahead as senior managers retire, and plan for its renewal. They would be required to think ahead of how technological innovations are continuing to change the way customers can bank. Boards would need to be fully empowered and have the necessary composition of skills for this purpose. Public sector banks thereby require boards that lead.[1]

This focus hitherto on public sector banks does not imply that private sector banks are free of governance blemishes. The incentivisation of the top managements in these banks could in theory lead to non-transparency in the reporting of the banks' performance. Is the bad-loans position worse than reported and camouflaged through evergreening in the interests of a favourable stock price valuation and the consequent superior valuation of management stock options? Are the boards, the audit committees and the auditors adequately vigilant in these matters? Is there the requisite focus on customer protection, particularly in the sale of third party products, where the new private sector banks have a dominant market share? As top managements in these banks are incentivised very differently to those in public sector banks,

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[1] An extensive management research literature has now developed on the efficacy or dysfunction of boards of firms, with both behavioural and normative approaches. A very recent addition to this genre is 'Boards that lead' by Ram Charan, Dennis Carey and Michael Useem, *Harvard Business Review Press*, 2014.

boards need to exercise continual vigilance in ensuring that managers' interests are aligned with, and do not ride roughshod over, those of shareholders.

2.2 Public Sector Banks Lose Market Share

Figure 2.1 displays (in the left hand bar for March 2000 and the central bar for March 2013) the market shares of banks differentiated according to ownership. Market share changes are visible on account of differences in the compounded annual growth rate (CAGR) in assets across these categories for the period 2000-13. We then - as a thought experiment - project linearly, using the same CAGR for each category to estimate market shares in March 2025, and these shares are displayed in the right hand bar. The world is clearly not linear, but the linear extrapolation of past growth rates into the future provides an intuitive feel for the significance of likely market structure changes over a quarter century from March 2000. Such a thought experiment leads to some unexpected inferences: First, the market share of the public sector banks will decline from 80 per cent in 2000 to just over 60 per cent in 2025. Second, the market share of private sector banks is projected to rise to about a third by 2025 from just over 12 per cent in 2000. Third, the foreign banks are projected to continue to remain marginal players in the market for bank assets. These projections suggest a very significant transformation in market structure over a quarter century.

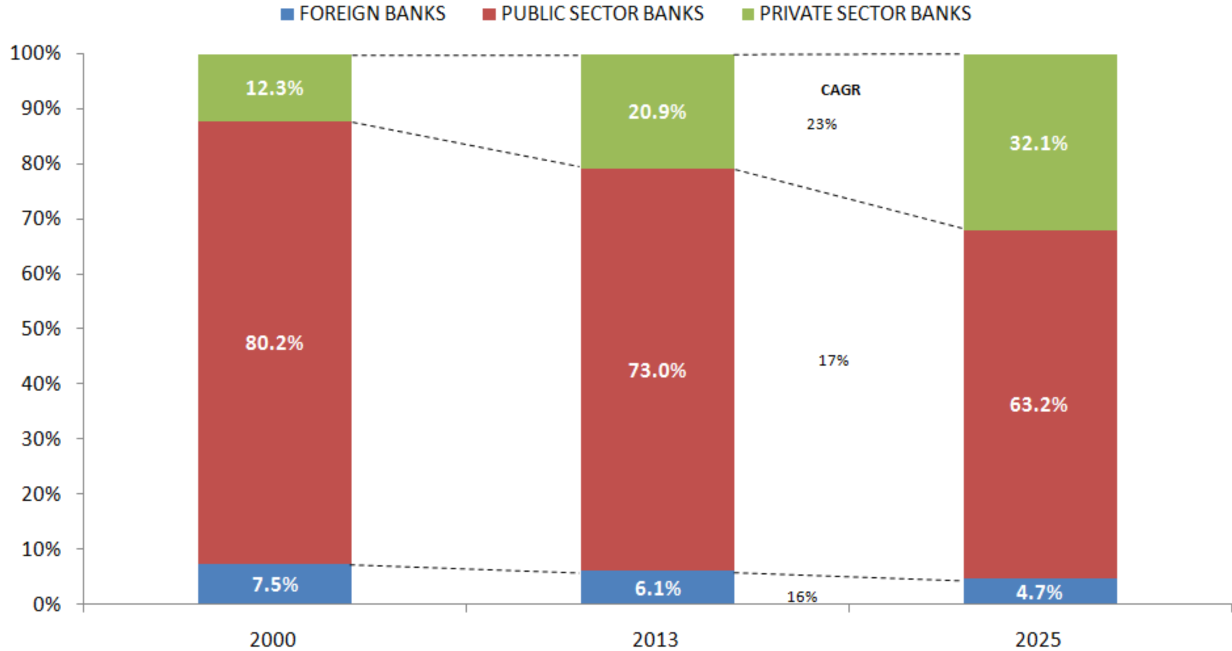

Figure 2.1: Estimates of market share based on linear projection

Linearity is an easy and critiquable first assumption, but there are at least three reasons why the private sector banks could do even better. First, with several more new private sector banks likely to be licensed over the next decade, their share could rise even faster.[2] Second, public sector banks will continue to face the dual problem of significant asset quality stress and slender capitalisation, impacting their growth, unless major governance changes occur and the Government is willing to dilute its stake so that the burden of raising additional capital falls more lightly on the Government. Even so, other institutional and sophisticated investors, who constitute the deeper pockets of capital, particularly from overseas, are unlikely to invest strongly in the absence of such governance changes and without optimism on productivity improvements.[3] Third, as the private sector banks have been more nimble and sustained in using new technologies to underpin their business models, it is likely they will continue to exercise a lead which could further accentuate the divide with public sector banks. A range of internet banking applications has already begun moving to the mobile handset, with smart phones and innovative applications offering customer convenience of a superior order. Even though the public sector banks have demonstrated their ability to catch up on new technology absorption, their lags in doing so are likely to enable private sector banks to capture market share more rapidly.

2.3 The Schism in Bank Profitability

There are several metrics which emphasise that public sector banks lag behind their private sector competitors in profitability. Figure 2.2 plots Return on Assets (RoA) for different bank segments from March 2005 till December 2013, and reveals how the new private sector banks have outstripped both the SBI group and the other public sector banks in the last five years. The private sector banks at end-December 2013 have reported an average RoA about four times that of public sector banks. Further, while the deceleration in economic growth in 2013-14 has lowered RoA in all bank segments, it is the public sector banks which have been the worst affected.

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[2] This process has already commenced, with RBI awarding provisional licenses in April 2014 for setting up two new private sector banks.

[3] For instance, the SBI qualified institutional placement launched in February 2014 targeted Rs. 9,600 crores, but was able to raise just Rs. 8,032 crores, of which over 40 per cent was contributed by LIC and public sector banks.

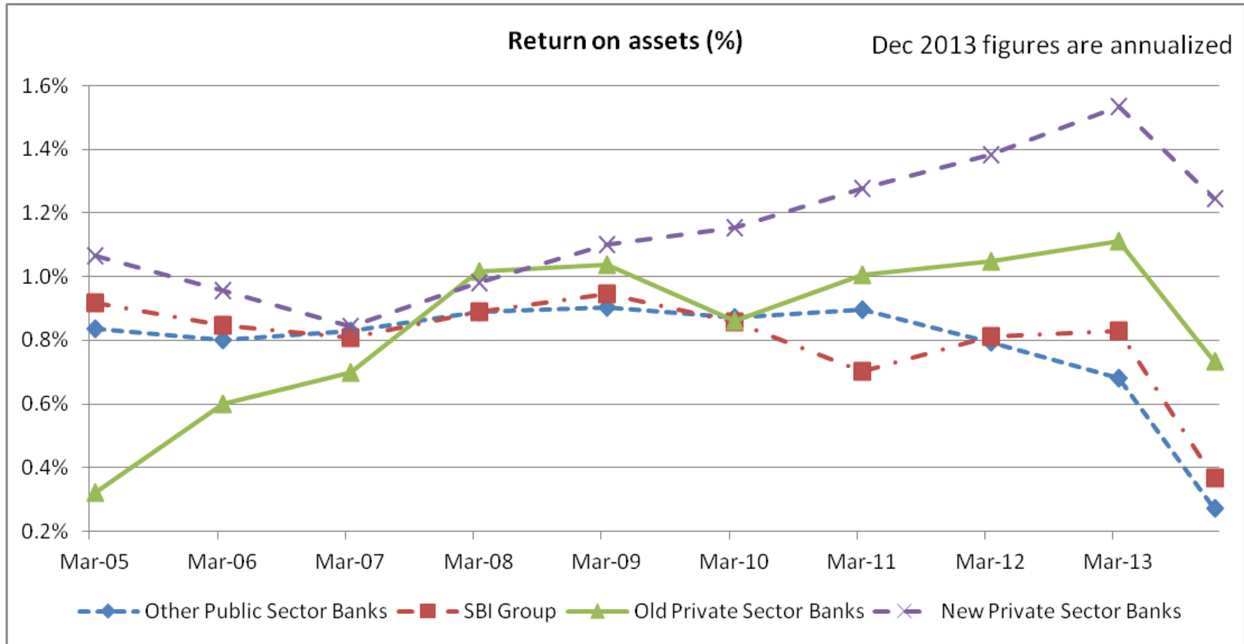


Figure 2.2: Return on assets

In order to provide some granularity to this contrasting profitability, Figure 2.3 displays a time-series for the average net interest margin for each bank segment over the same period. The margins reported by private sector banks are higher and have progressively widened in recent years in relation to their public sector bank peers, even though margins in the SBI group have generally remained stable in the recent period.

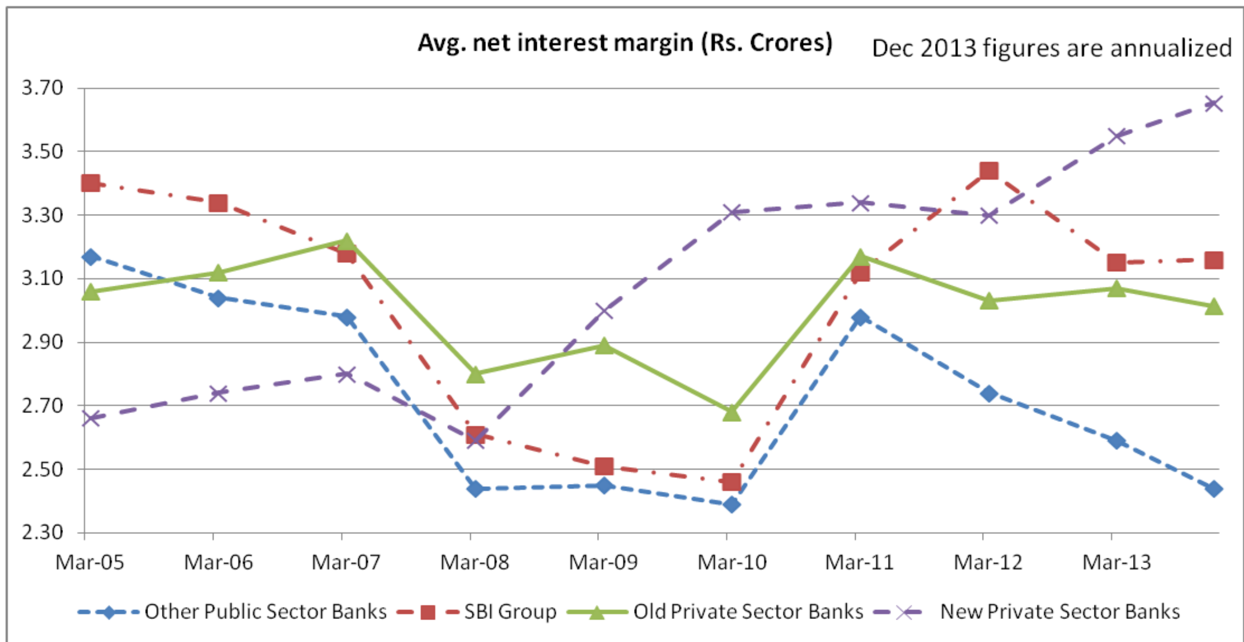


Figure 2.3: Net interest margin

There are other ways in which productivity differences are seen to be reflected in lower profitability. Figure 2.4 provides a time series on net profit per employee, which for the new private sector banks has been rising steadily since 2008, and is about four times that of the SBI Group in the year ended March 2013. Figure 2.5 demonstrates that staff costs as a proportion of operating expenses for the new private sector banks, though rising since 2005, are nevertheless over 15 per cent less than the other public sector banks in the year ended March 2013.[4] Similarly, Figure 2.6 demonstrates that across recent years, fees as a proportion of operating income were significantly higher in new private sector banks. In the year ended March 2013 fees were 7 per cent of operating income for the SBI group, as low as 3 per cent for other public sector banks, and 12 per cent for new private sector banks.

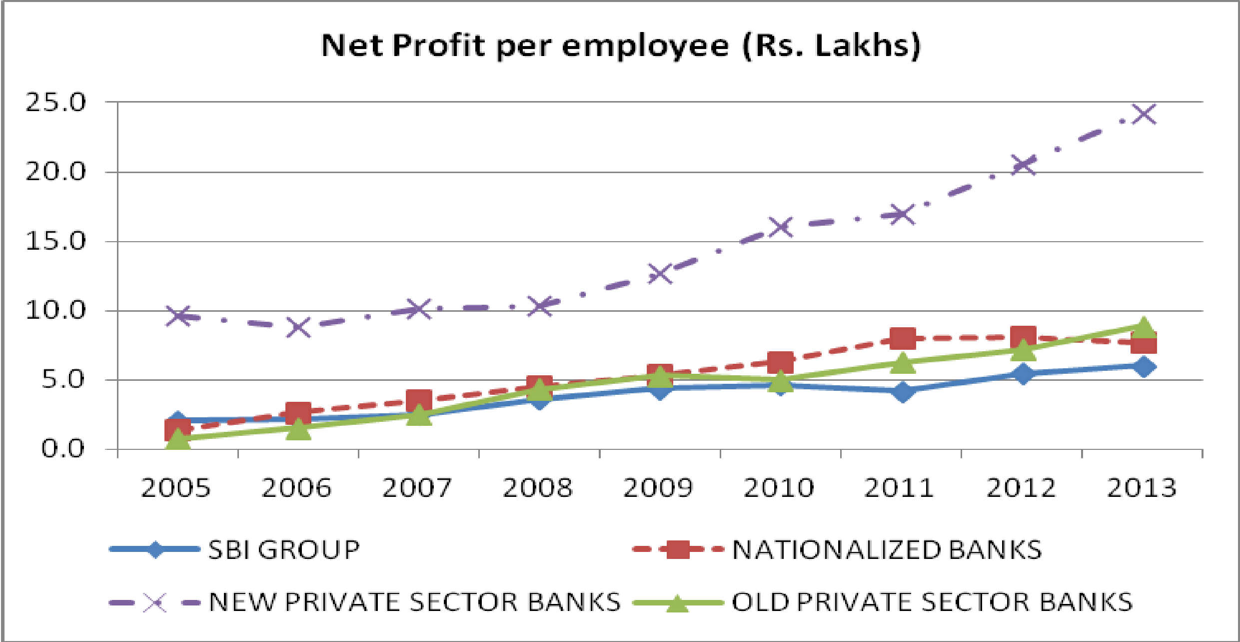


Figure 2.4: Profitability per employee

[4] The divergence in employee costs is also on account of new private sector banks outsourcing functions more actively than either the SBI Group or the other public sector banks do.

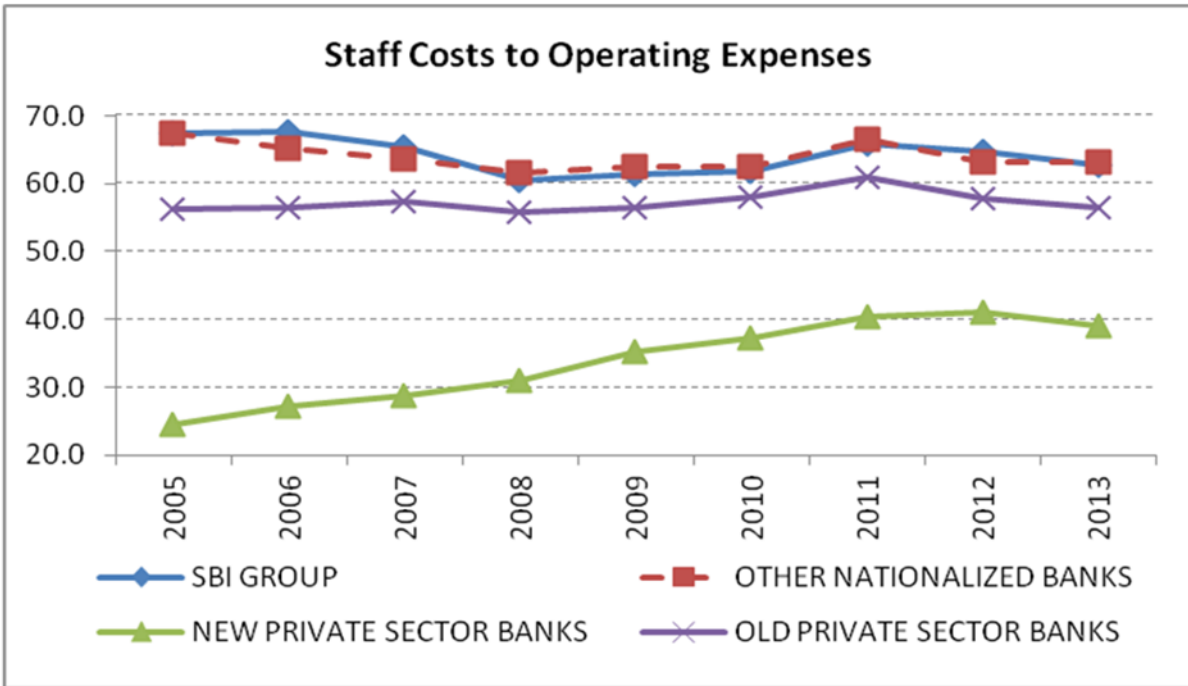


Figure 2.5: Employee costs

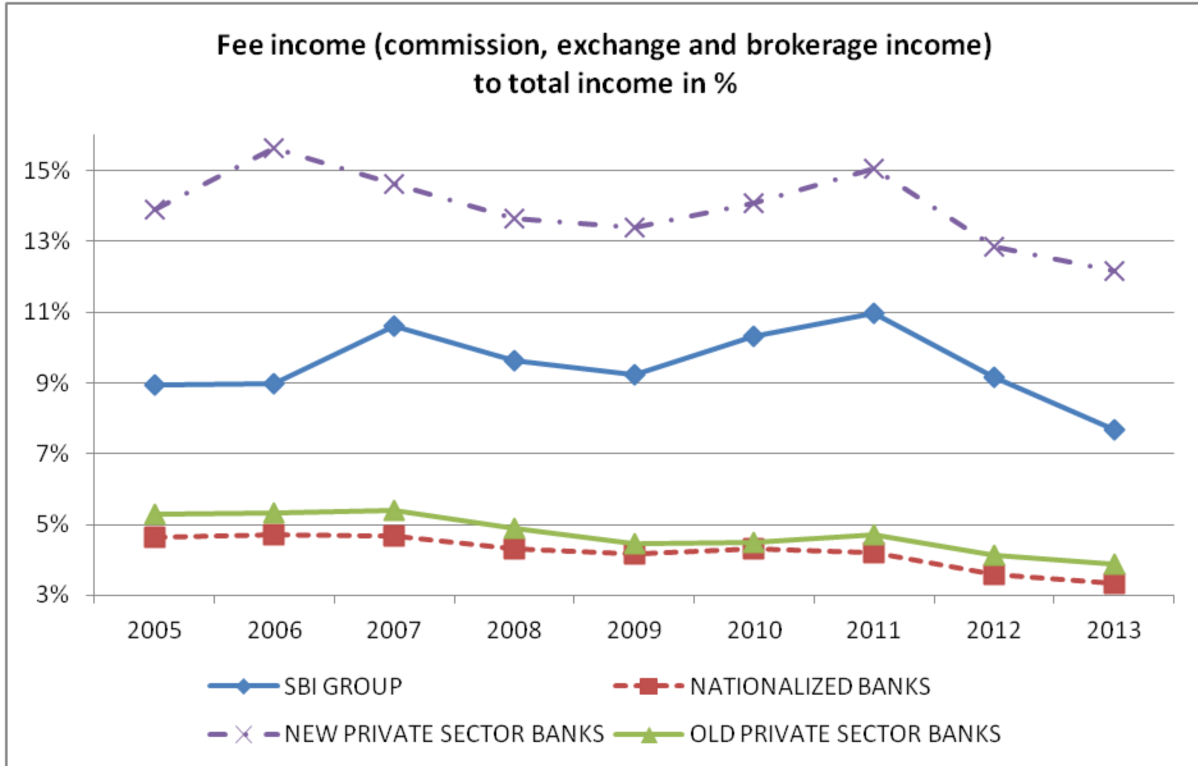


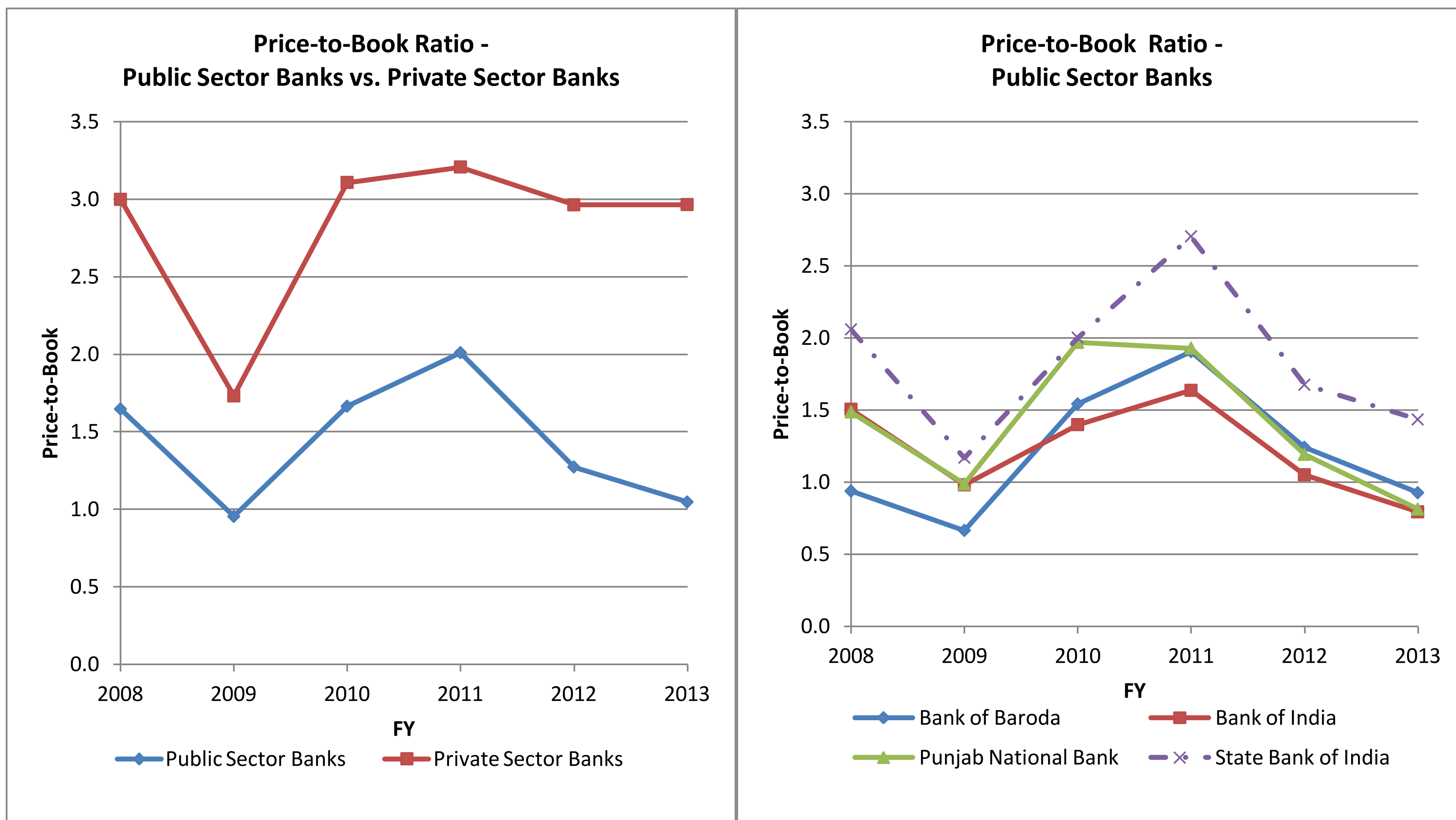
Figure 2.6: Fee income

This profitability schism is reflected in the average market valuation multiples of different bank segments. Figure 2.7 demonstrates that at end-March 2013, while public sector banks had an average price-to-book multiple of one, for private sector banks it was three, and the difference in market valuation has widened in recent years.[5] It is also apparent that SBI has had a valuation multiple superior to several of the other large public sector banks.

2.4 Deterioration in Asset Quality

During 2013-14, loan asset quality in banks has deteriorated at a frightening pace. At the quarter ended December 2013 banks collectively held loan provisions of Rs. 98,593 crores, an increase of 13 per cent over the provisions held a year earlier, as Table 2.1 demonstrates. Moreover, of this amount, Rs. 32,295 crores of provisions were held by the SBI group and Rs. 45,357 crores were held by the other public sector banks, as indicated in Tables 2.2 and 2.3. Thus 79 percent of total bank provisions were held by public sector banks, demonstrating the high level of stress visible in these banks. This has taken its toll on quarterly profitability for public sector banks, which has fallen 30 per cent for the SBI group within a year and 39 per cent for other public sector banks. For these bank segments provisioning is nevertheless inadequate, as net NPAs as a proportion of net advances have risen 50 per cent in a year for the SBI group and 41 per cent for other public sector banks. Even gross NPAs as a proportion of gross advances have increased significantly over the last year for the SBI group and the other public sector banks (Figure 2.8). Capital too has eroded, with net NPAs as a proportion of net worth rising 40 per cent in a year for the SBI group and 25 per cent for other public sector banks.

[5] Figures 2.7, 2.10 and 2.11 are based on the analysis in Acharya, Oncu and Phadnis, 'Zombie Banks', *Working Paper*, NYU Stern School of Business, 2014.



All figures for March end of each year

Figure 2.7: Price-to-book ratios

All Banks						
Variable	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**CAGR**
Earnings Before Provisions & Taxes	130,664	179,563	51,620	96,064	141,864	9%
Gross NPAs to Gross Advances (%)	3.69	3.42	4.00	4.22	4.40	19%
Net NPAs	85,135	88,285	111,529	128,455	139,111	63%
Net NPAs to Net Advances (%)	1.73	1.68	2.13	2.34	2.49	44%
Profit after Tax	62,038	84,125	22,761	37,354	53,009	-15%
Profit before tax	90,685	118,675	33,997	55,838	80,599	-11%
Provisions for Credit Losses	87,608	79,520	86,547	94,988	98,593	13%
Net NPAs to Net Worth (%)	17.12	13.23	16.03	17.83	18.94	10.65

All amounts in Rs. Crore

Table 2.1: Performance indicators for all banks

SBI Group						
Variable	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**CAGR**
Earnings Before Provisions & Taxes	27,234	36,300	9,056	16,183	24,419	-10%
Gross NPAs to Gross Advances (%)	5.34	4.80	5.77	5.90	6.24	17%
Net NPAs	26,366	23,081	32,407	38,603	45,022	71%
Net NPAs to Net Advances (%)	2.35	1.90	2.70	3.08	3.53	50%
Profit after Tax	11,749	15,377	4,068	6,021	8,228	-30%
Profit before tax	17,951	21,963	5,711	8,375	12,097	-33%
Provisions for Credit Losses	28,579	28,704	31,116	33,479	32,295	13%
Net NPAs to Net Worth (%)	25.00	19.04	25.85	30.33	35.12	40.47

All amounts in Rs. Crore

Table 2.2: Performance indicators for the SBI Group

Other PSBs						
Variable	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**CAGR**
Earnings Before Provisions & Taxes	56,118	76,829	22,304	40,370	59,165	5%
Gross NPAs to Gross Advances (%)	3.66	3.42	4.06	4.34	4.55	24%
Net NPAs	50,676	57,234	69,117	78,482	81,798	61%
Net NPAs to Net Advances (%)	1.99	2.08	2.55	2.74	2.81	41%
Profit after Tax	22,866	30,473	7,843	10,648	13,932	-39%
Profit before tax	30,264	38,033	11,089	14,900	19,655	-35%
Provisions for Credit Losses	39,216	31,747	35,867	40,959	45,357	16%
Net NPAs to Net Worth (%)	23.00	21.92	25.76	28.13	28.76	25.04

All amounts in Rs. Crore

Table 2.3: Performance indicators for other public sector banks

New Private Sector Banks						
Variable	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	CAGR
Earnings Before Provisions & Taxes	26,585	37,521	11,024	22,148	34,168	29%
Gross NPAs to Gross Advances (%)	2.02	1.91	1.94	1.95	1.96	-3%
Net NPAs	3,348	3,343	3,981	4,416	5,188	55%
Net NPAs to Net Advances (%)	0.45	0.44	0.51	0.54	0.61	36%
Profit after Tax	15,356	21,723	6,027	12,080	18,997	24%
Profit before tax	22,667	31,734	9,142	18,291	28,891	27%
Provisions for Credit Losses	11,560	11,262	11,184	11,399	11,423	-1%
Net NPAs to Net Worth (%)	2.00	2.21	2.46	2.59	2.95	47.40

All amounts in Rs. Crore

Table 2.4: Performance indicators for new private sector banks

Old Private Sector Banks						
Variable	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	CAGR
Earnings Before Provisions & Taxes	6,091	8,467	2,608	4,753	6,676	10%
Gross NPAs to Gross Advances (%)	2.20	1.91	2.28	2.39	2.34	6%
Net NPAs	2,151	1,982	2,636	3,011	3,143	46%
Net NPAs to Net Advances (%)	0.86	0.74	0.98	1.09	1.11	29%
Profit after Tax	3,587	4,940	1,212	2,361	3,434	-4%
Profit before tax	5,181	6,899	1,789	3,326	4,844	-7%
Provisions for Credit Losses	3,202	2,527	2,813	2,949	2,887	-10%
Net NPAs to Net Worth (%)	6.00	6.11	7.83	8.18	8.32	38.66

All amounts in Rs. Crore

Table 2.5: Performance indicators for old private sector banks

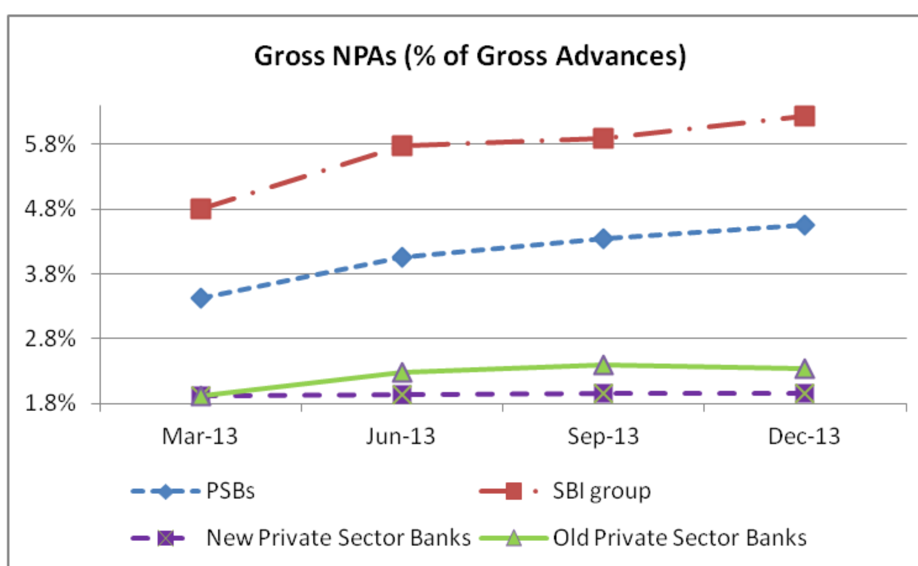


Figure 2.8: Gross NPAs

These are disconcerting numbers, and the contrast with the reported financials of the old and new private sector banks, provided in Tables 2.4 and 2.5 respectively, is stark. Despite an increase in net NPAs as a proportion of net advances of 36 per cent and 29 per cent respectively for the new and old private sector, these increases have been from a modest base. As of December 2013, net NPAs as a proportion of net advances equalled 0.61 per cent for the new private sector banks and 1.11 per cent for the old private sector banks. Though there has been some erosion in capital, as witnessed in the growth in net NPAs as a proportion of net worth by 47 per cent in the new private sector banks and 39 per cent in the old private sector banks, these increases have again been from modest levels. Although balance sheet quality and capital have been eroded in the private sector banks, the wounds are not deep. However, despite the increase in the NPAs, loan provisions held have declined by 1 per cent for the new private sector banks and by 10 per cent for the old private sector banks.

NPAs represent one kind of stressed assets, and the regulatory forbearance provided by RBI to restructure assets constitutes another form.[6] In recent years restructured assets have burgeoned. Figure 2.9 demonstrates that while restructured assets as a proportion of advances have risen in the last 3 years to 4 per cent for the SBI group and a disconcertingly high 7.5 per cent for the other public sector banks, they have remained largely stable at 1.5 per cent for the private sector banks.

2.5 Leverage and Funding Patterns

Figure 2.10 indicates that in 2012-13 the average leverage ratio (defined as the ratio of total assets of a bank to its equity capital) was about 16.5 per cent for public sector banks as against about 10 per cent for private sector banks. A higher leverage, implying lower equity capital to support the bank's business, enhances the default risk of the bank. Thereby, a macroeconomic shock which could reduce the value of bank assets will put public sector banks at greater risk.

[6] Another form of regulatory forbearance, whose extent and implications are difficult to quantify (as RBI does not collect data on it) is the facility for banks to refinance rupee loans through foreign currency loans extended by other banks against a standby letter of credit (akin to a guarantee) extended by the banks which had sanctioned the earlier rupee loans, provided the company has export proceeds which cover at least 75 per cent of the loan amount. The rupee asset needs to be standard, so if it approaches impending NPA status it is in the bank's interest to have it refinanced. This regulatory forbearance has been withdrawn by RBI in April 2014.

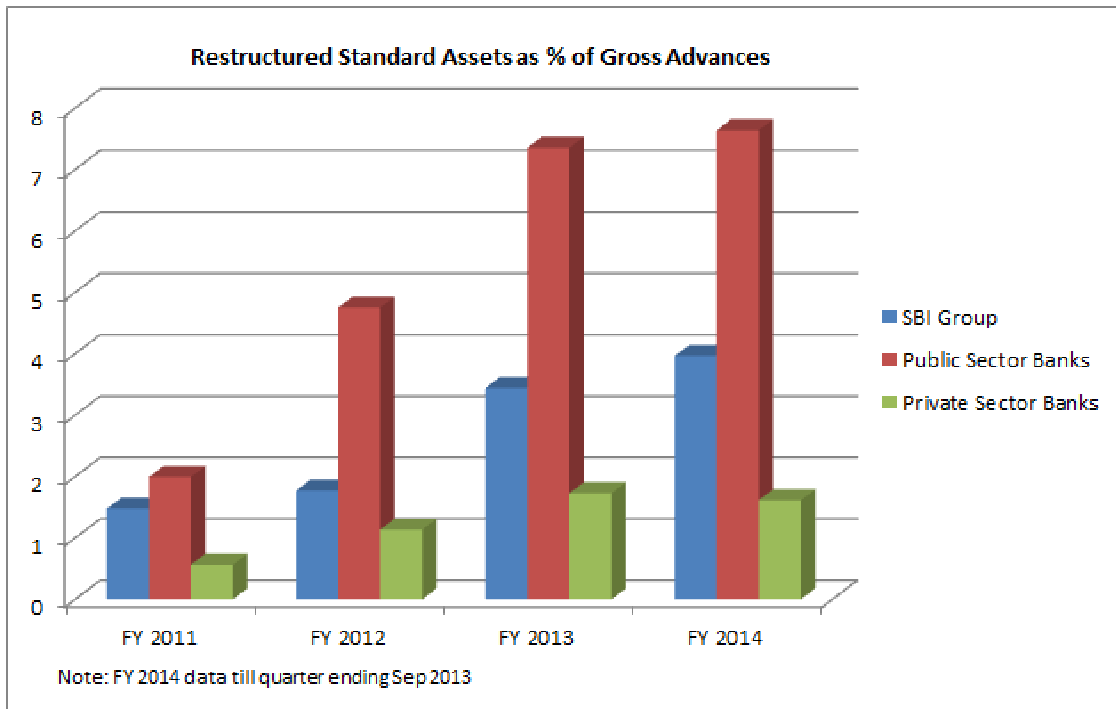


Figure 2.9: Restructured assets

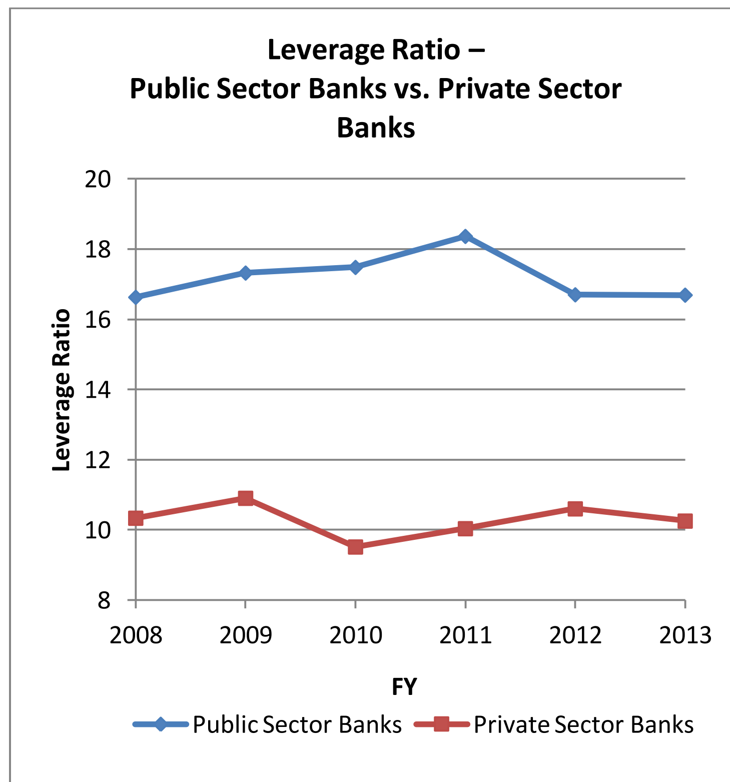


Figure 2.10: Leverage ratios

Apart from being more highly levered, public sector banks are significantly more reliant on volatile wholesale liabilities for their funds when compared to their private sector competitors. As Figure 2.11 indicates, public sector banks' wholesale liabilities as a proportion of total liabilities have risen to 37 per cent in September 2013, while for private sector banks it has fallen to 24 per cent.[7] More worryingly, as Table 2.6 reveals, there are nine public sector banks, and just one private sector bank, where the wholesale proportion exceeded 45 per cent in March 2013. The academic finance literature, too, cautions that a combination of fast asset growth and a high proportion of wholesale funding increases bank vulnerability in the event of a liquidity squeeze (See Box 2.1).

Box 2.1: High asset growth with high wholesale liabilities as an indicator of vulnerability

Hahm, Shin and Shin, "Non-core bank liabilities and financial vulnerability", *Journal of Money, Credit and Banking* 2013, investigate the role of non-core bank liabilities (components of funding other than retail deposits) in signalling financial vulnerability. They formulate a credit supply model where a bank maximizes profit subject to a Value-at-Risk (VAR) constraint. Banks are able to expand lending without violating the constraint when measured risks are low. However, when core deposits do not grow in line with credit supply, banks turn to other sources of funding to support their credit growth, typically from other banks operating as wholesale lenders in the capital market. An important link is established between currency crises and credit crises as the pro-cyclical behaviour that fuels the credit boom is financed through capital inflows via the banking sector. Empirically, authors find support for this hypothesis. Measures of non-core liabilities, and especially the liabilities to the foreign sector, serve as a good indicator of the vulnerability to a crisis, both of a collapse in the value of the currency as well as a credit crisis where lending rates rise sharply. This suggests that traditional banks – with a heavy reliance on deposit funding – are safer than banks with strategies that rely prominently on attracting wholesale funding. Furthermore, at least in developing economies, noncore bank liabilities may be usefully monitored as a complementary measure to the credit to GDP ratio in gauging the stage of the financial cycle and the build up of financial risk.

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[7] To the extent that public sector banks hold a larger proportion of government securities, the risk of leverage is reduced.

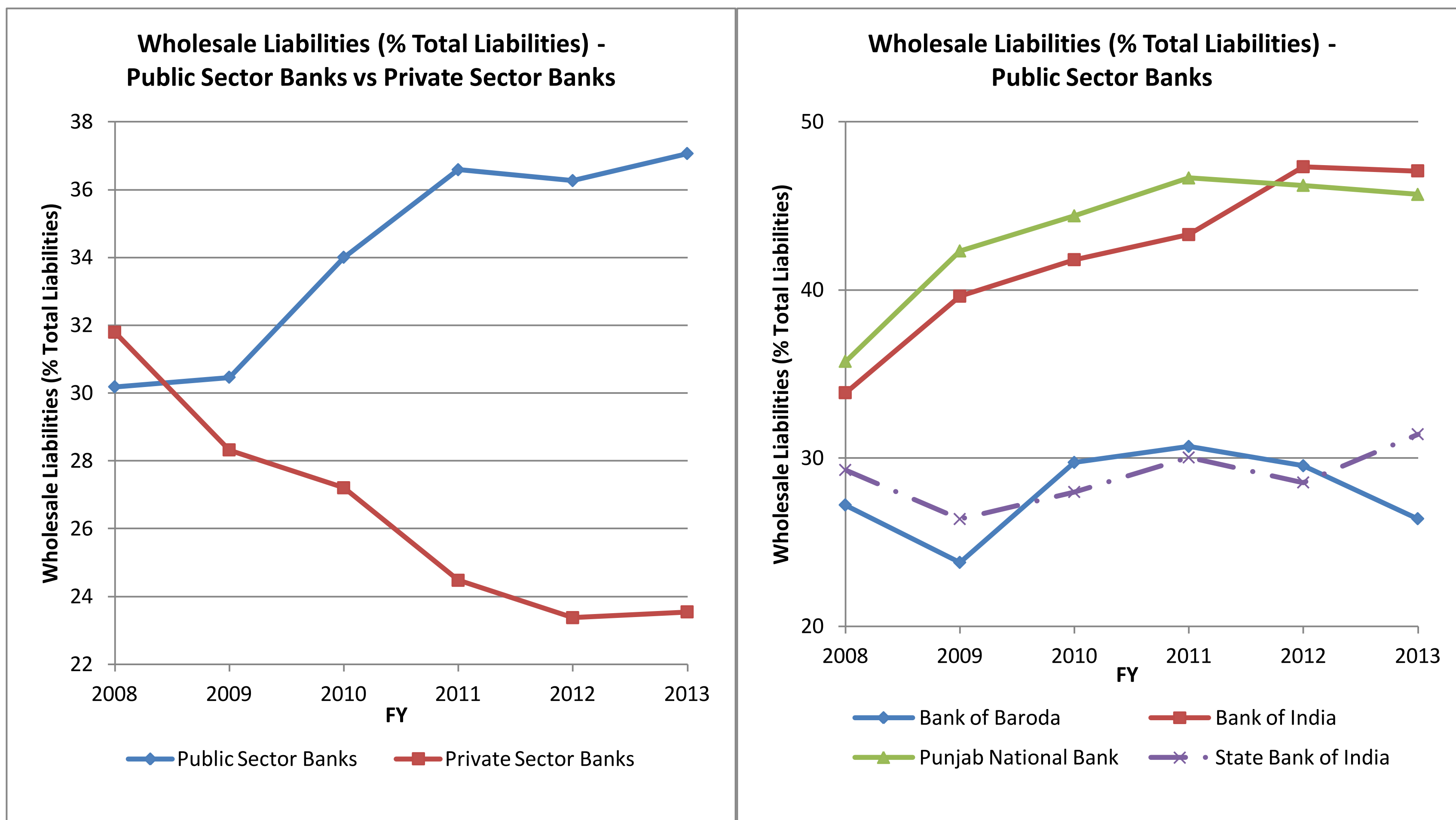

Figure 2.11: Wholesale liabilities

Bank	Mar-13
Central Bank Of India	54.67
Oriental Bank Of Commerce	53.61
Syndicate Bank	51.64
Punjab & Sind Bank	50.40
UCO Bank	50.10
Yes Bank Ltd.	47.95
IndusInd Bank Ltd.	47.52
Bank Of India	47.08
Punjab National Bank	45.68
State Bank Of Mysore	45.12
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Bank Of Baroda	26.39
Kotak Mahindra Bank Ltd.	25.76
Dhanlakshmi Bank Ltd.	22.23
City Union Bank Ltd.	21.37
Karur Vysya Bank Ltd.	20.97
HDFC Bank Ltd.	20.69
Lakshmi Vilas Bank Ltd.	20.21
ICICI Bank Ltd.	19.97
Axis Bank Ltd.	18.58
Development Credit Bank Ltd.	5.52

Table 2.6: Wholesale liabilities as a % of total liabilities for select banks

2.6 Capital Requirements

Regulatory requirements in most banking jurisdictions are now increasing the extent of capital to support banking institutions, and RBI too is in step with this. Table 2.7 indicates the progressively higher capital requirements each year stipulated by RBI in March 2014. As at end-March 2014, RBI required a minimum tier-I capital as a proportion of risk assets of at least 6.5 per cent and requires a higher 7.0 per cent as at end-March 2015. As at end-September 2013, eight public sector banks were not in compliance with the tier-I capital requirements for end-March 2014, while five public sector banks were marginally above the thresholds. However, even the existing tier-I capital for public sector banks is overstated because of the regulatory forbearance which RBI provides on restructured assets. Without forbearance these assets would be categorised as NPAs, the restructuring being a response to likely imminent default. As a consequence, provisioning would rise and tier-I capital would fall.

Minimum capital ratios	1-Apr-13	31-Mar-14	31-Mar-15	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19
Minimum Common Equity Tier 1 (CET1)	4.500%	5.000%	5.500%	5.500%	5.500%	5.500%	5.500%
Capital conservation buffer (CCB)	-	-	-	0.625%	1.250%	1.875%	2.500%
Minimum CET1+ CCB	4.500%	5.000%	5.500%	6.125%	6.750%	7.375%	8.000%
Minimum Tier 1 capital (Min. CET1+Additional Tier 1)	6.000%	6.500%	7.000%	7.000%	7.000%	7.000%	7.000%
Minimum Total Capital (Tier 1 + Tier 2)	9.000%	9.000%	9.000%	9.000%	9.000%	9.000%	9.000%
Minimum Total Capital + CCB	9.000%	9.000%	9.000%	9.625%	10.250%	10.875%	11.500%

Table 2.7: Basel 3 capital requirements

In order to comprehend the implications of such regulatory forbearance, it is helpful to construct a consolidated balance sheet of all public sector banks as at end-December 2013. Based on reported financial results the consolidated balance sheets are shown in Tables 2.8A and 2.8B. Table 2.8A contains the consolidated balance sheet in Rs. Crores, while Table 2.8B presents the same balance sheet with the net loans and advances normalised to Rs. 100. This indicates that equity held by the consolidated public sector banks is 10.6 percent of loan assets and tier-I capital adequacy is 9.7 per cent. It appears that the tier-I capital position (benchmarked to RBI's 6.50 per cent tier-I capital adequacy threshold for end-March 2014) is comfortable. But this comfort is on account of regulatory forbearance and the low provision cover that banks currently hold.

In 2009 RBI had issued guidelines to banks stipulating the desirability of holding a provision cover (defined as provisions held as a proportion of gross NPAs) of at least 70 per cent, though very few banks (in the public and private sector) have been able to adhere to this norm, as higher provisioning depresses profits. When banks are unable to adhere to this provision cover on a continual basis, they are in danger of accumulating a provisioning backlog which could put future profits and capital in greater jeopardy.

Assets		Capital & Liabilities	
Net loans and advances	4,182,892	Customer Deposits	5,648,489
Other interest bearing assets	2,227,962	Non-equity Tier 1 capital	16,023
Non-interest bearing assets*	384,331	Other interest bearing liabilities	97,908
		Non interest bearing liabilities*	588,012
		Total shareholders equity	444,754
Total Assets	6,795,186	Total Cap & Liabilities	6,795,186
*derived items			
Impact on shareholders equity from additional provisioning:			
Additional Provisions			
Scenario 1:			
70% *(Gross NPA + Restr. Assets)	278,567	Written down shareholders equity	166,187
Scenario 2:			
70% *(Gross NPA + 0.3* Restr. Assets) + 3.25% * (0.7* Restr. Assets)	142,436	Written down shareholders equity	302,318
Scenario 3:			
50% *(Gross NPA + 0.3* Restr. Assets) + 3.25% * (0.7* Restr. Assets)	81,448	Written down shareholders equity	363,306

Table 2.8A: Consolidated Balance Sheet for all Public Sector Banks in Rs. Crores (as of Dec-2013)

Assets		Capital & Liabilities	
Net loans and advances	100.0	Customer Deposits	135.0
Other interest bearing assets	53.3	Non-equity Tier 1 capital	0.4
Non-interest bearing assets*	9.2	Other interest bearing liabilities	2.7
		Non interest bearing liabilities	14.1
		Total shareholders equity	10.6
		Tier-I CAR	9.7
Total Assets	162.5	Total Cap & Liabilities	162.5
Impact on shareholders equity from additional Provisioning:			
Scenario 1:			
70% *(Gross NPA + Restr. Assets)	6.5	Written down shareholders equity	4.0
		Written down Tier-I CAR	3.8
Scenario 2:			
70% *(Gross NPA + 0.3* Restr. Assets)	3.4	Written down shareholders equity	7.2
+ 3.25% * (0.7* Restr. Assets)		Written down Tier-I CAR	6.7
Scenario 3:			
50% *(Gross NPA + 0.3* Restr. Assets)	1.9	Written down shareholders equity	8.7
+ 3.25% * (0.7* Restr. Assets)		Written down Tier-I CAR	8.0

Table 2.8B: Normalized consolidated Balance Sheet for all Public Sector Banks (as of Dec-2013)

We therefore list 3 scenarios below which attempt to ascertain the impact on public sector banks' tier-I capital at the end of December 2013 due to a tighter discipline on NPA and restructured assets recognition, and provisioning:

Scenario 1: No regulatory forbearance on restructured assets is available and a 70 per cent provision cover is required. In this extremely prudent scenario, capital then gets written down by Rs. 2,78,567 crores to a tier-I capital adequacy of 3.8 percent, as Table 2.8B indicates. This represents a stark shortfall in tier-I compared to the regulatory requirement for end-March 2014.

Scenario 2: Regulatory forbearance is available in terms of RBI's present norms for restructured assets, together with the need to maintain a 70 per cent provision cover. Further, a 4.25 per cent provision cover is maintained for restructured assets. We also project in this scenario that 30% of outstanding restructured assets would convert each year into NPAs. In this scenario, which is less prudent, capital then gets written down by a less onerous Rs. 1,42,436 crores and tier-I capital adequacy rises to 6.7 per cent as Table 2.8B demonstrates, which is just above the regulatory requirement for end-March 2014.

Scenario 3: Regulatory forbearance is available as before, and the provision cover is lowered to 50 per cent. As in Scenario 2, a 4.25 per cent provision cover is maintained for restructured assets and 30% of restructured assets are projected to be converted into NPAs. This is a weaker discipline imposed on banks, capital then gets written down by a more modest Rs. 81,448 crores, and tier-I rises further to 8.0 per cent as Table 2.8B reveals. This capital situation is comfortable for end-March 2014 and end-March 2015.

A similar exercise conducted for the new private sector banks reveals that tier-I capital adequacy is 12.2 per cent under Scenario 1, 12.9 per cent under Scenario 2, and 13.3 per cent under Scenario 3. Clearly, the new private sector banks are much more comfortably capitalised, and the variance between the three scenarios is low.

It is also necessary to make projections for future tier-I capital for public sector banks. These projections for the medium term are more uncertain because of the likely needs for heavy loan loss provisions. We project the capital requirements for all public sector banks in Table 2.9. We assume assets to grow at a nominal growth rate of 16 per cent. Given the recent deterioration in the quality of assets, we assume that the ratio of gross NPAs to risk weighted assets, the ratio of restructured assets to risk weighted assets, and the ratio of provisions to risk weighted assets in the period up to March 2018 would equal their averages over the one year ended December 2013. We also assume that the return on equity and the payout ratios would equal their historical averages estimated over the last three years. Further, we assume that 30% of outstanding restructured assets would convert into NPAs every year. Finally, we provide for a 3.5 per cent provision cover for restructured assets for FY 2013-14, 4.25 per cent for FY 2014-

15, and a 5 per cent cover for restructured assets thereafter. Using these assumptions, we estimate the tier-I capital required up to FY 2018 under the three provisioning scenarios as mentioned above. These estimates indicate that the additional tier-I capital required up to FY 2018 equals Rs. 2.10 lakh crores in Scenario 3, Rs. 3.19 lakh crores in Scenario 2 and 5.87 lakh crores in the extremely prudent Scenario 1.

In scenario 1, public sector banks would need Rs. 5.87 lakh crores of tier-I capital during the period January 2014 – March 2018. Assuming that the Government puts in 60 per cent (though it will be challenging to raise the remaining 40 per cent from the capital markets), the Government would need to invest over Rs. 3.50 lakh crores. These banks are unlikely to raise more than a marginal amount of this capital through non-equity sources. Increasingly, therefore, the capital needs of public sector banks, burgeoning because of loan loss provisions, could begin to affect India's fiscal health unless an overhaul of bank governance can lead to the better management of public sector banks and thereby to lower capital needs. Even in the least prudent Scenario 3, public sector banks would need Rs. 2.10 lakh crores of Tier-I capital during this period with Government having to invest Rs. 1.26 lakh crores.

These projections assume that capital adequacy is at the minimum laid down under Basel 3 as indicated in Table 2.7. Well-run banks would typically hold capital much above this minimum, necessitating additional capital having to be raised. Further, the projections are very sensitive to the assumption that certain proportions such as the gross NPA ratio or the restructured assets ratio do not worsen in the next four years. If they do, the capital needs will further increase. Similarly, the projections assume that risk weighted assets will grow at 16 per cent. If the business cycle were to turn and economic growth to accelerate, a faster growth in these assets would need to be supported by further enhanced capital. The projections above under the three Scenarios therefore represent lower bounds for the likely capital needs of public sector banks.

The diagnostic and discussion in this chapter demonstrate that while several factors could have led to their present difficulties, public sector banks cannot continue to be governed and managed in the existing manner without greater financial damage in the years ahead. The Recommendation below provides a backdrop to the more detailed recommendations which follow:

<u>Recommendation 2.1</u>: *Given the lower productivity, steep erosion in asset quality and demonstrated uncompetitiveness of public sector banks over varying time periods (as evidenced by inferior financial parameters, accelerating stressed assets and declining market share), the recapitalisation of these banks will impose significant fiscal costs. If the governance of these banks continues as at present, this will impede fiscal consolidation, affect fiscal stability and eventually impinge on the Government's solvency. Consequently, the Government has two*

options: either to privatise these banks and allow their future solvency to be subject to market competition, including through mergers; or to design a radically new governance structure for these banks which would better ensure their ability to compete successfully, in order that repeated claims for capital support from the Government, unconnected with market returns, are avoided.

Assumptions:			
Growth rate for risk weighted assets (%)	16%	Provisions/ Risk weighted assets	2%
Gross NPA/ Risk weighted assets	4%	ROE (%)	15.6%
Restructured assets/ Risk weighted assets	7%	Payout ratio (%)	23.0%
% of restructured assets converting into NPA	30%		

Projected financials under normal conditions:			All amounts in Rs. thousand crores			
	Dec-13	**2014E**	**2015E**	**2016E**	**2017E**	**2018E**
Risk Weighted Assets	4757	4937	5727	6643	7706	8939
Gross NPA	218	205	238	276	320	371
Restructured Assets	291	325	377	437	507	588
Net Profit	57	71	80	89	100	112
Net Worth	413	456	511	572	641	717
Provisions held	78	89	103	119	139	161
Provisions required under stress scenarios:						
Scenario 1: 70% *(Gross NPA + Restr. Assets)	356	371	430	499	579	671
Scenario 2: 70% *(Gross NPA + 0.3* Restr. Assets) + x% * (0.7* Restr. Assets)	220	220	257	300	348	404
Scenario 3: 50% *(Gross NPA + 0.3* Restr. Assets) + x% * (0.7* Restr. Assets)	159	159	187	219	254	294
Additional provisions required under stress scenarios:						
Scenario 1:	279	282	327	379	440	511
Scenario 2:	142	131	154	181	210	243
Scenario 3:	81	70	84	99	115	134
Tier I Capital required:						
Min Tier I plus Capital Conservation Buffer (%)	6.500%	6.500%	7.000%	7.625%	8.250%	8.875%
Level of Tier-I Capital required	309	321	401	507	636	793
Shortfall in Capital required to meet threshold requirements:						
Scenario 1:	175	147	217	314	435	587
Scenario 2:	39	-	44	115	205	319
Scenario 3:	-	-	-	34	110	210

Note 1: Provisions held for restructured assets x=3.5% for FY 2014-15, 4.25% for 2014-15 and 5% thereafter

Note 2: Other than for Net Profit, the columns display end-period cumulative estimates. Dec-13 data are actual.

Table 2.9: Projected capital requirements for public sector banks till FY 2018

2.7 Easing External Constraints on Public Sector Banks

Part of the reason for the governance difficulties which public sector banks face arises from a number of constraints they confront, many externally imposed on them, others internal to their functioning. The Government and RBI need to move to first remove the external constraints imposed upon them, so that these banks are not disadvantaged in relation to private sector banks, which are uninhibited by them.

In this Chapter we merely list these constraints, and discuss them in greater detail later in the Report. The existence of these constraints denies the public sector banks a level playing field in relation to their private sector peers, and thereby disadvantages them. The external constraints include the following:

1. Dual regulation, by the Finance Ministry in addition to RBI. The Finance Ministry's directives could be both explicit (through the issue of guidelines) and through undocumented suasion. For instance, in the period October 2012 to January 2014 the Finance Ministry issued 82 circulars to public sector banks. Private sector banks are free of dual regulation.

2. Board constitution. All directors (other than shareholder-elected ones) are appointed by the Government. It is unclear how any of them can then be deemed as independent, leading to an egregious violation of Clause 49 of SEBI's Listing Guidelines. Unlike in private sector banks, the boards have no governance role or control over bringing in directors with special skills. Average tenures of Chairmen and Executive Directors are short, all of which lead to the weak empowerment of boards. The contrast with the boards of private sector banks is sharp.

3. Significant and widening compensation differences between public sector and private sector banks, leading over time to skill differences, particularly for certain key and specialised positions.

4. External vigilance enforcement, through the CVC and CBI, which could inhibit the desire to take commercial risks otherwise deemed acceptable. It also puts a premium on fidelity to process, and slows decision-making. Private sector banks handle vigilance solely through internal enforcement.

5. Applicability, although in a limited way, of the Right to Information Act. Private sector banks are free of this.

The Government and RBI need to strive to introduce a level playing field, in terms of the following Recommendation:

Recommendation 2.2: *There are several external constraints imposed upon public sector banks which are inapplicable to their private sector competitors. These constraints encompass dual regulation (by the Finance Ministry, and by RBI, which goes substantially beyond the discharge of a principal shareholder function); the manner of appointment of directors to boards; the short average tenures of Chairmen and Executive Directors; compensation constraints; external vigilance enforcement; and applicability of the Right to Information Act. Each of these constraints disadvantages these banks in their ability to compete with their private sector competitors. The Government and RBI need to move to rapidly eliminate or significantly reduce these constraints, in the absence of which managements of public sector banks will continue to face an erosion of competitiveness. Further, it is only after these external constraints have been addressed would it be practicable for public sector banks to address a host of internal weaknesses which affect their competitiveness.*

Chapter 3

The Content of Board Deliberations

3.1 Objectives and Methodology

There are three aspects of governance in the boards of India's domestic banks which this Report attempts to analyse: First, the content of deliberations in boards with a view to understanding the types of issues which receive attention. Is there an adequate focus on issues critical to banks' growth and the risks they face? Do bank boards discuss predominantly strategic rather than tactical issues? Second, does the manner in which the relationship between each bank's principal owner and the bank is configured have implications for the empowerment of the board? This has particularly distinctive features when the principal shareholder is the Government. Third, are adequate skills available in boards in relation to the complex objectives confronting the banks? Here too there is a variance between public sector and private sector banks, with challenges for the former which are largely absent in the better run private sector banks.

In this Chapter we examine the content of board deliberations. We focus on a specific methodology for such assessment, based on an examination of board notes and minutes of the meetings convened to discuss the second quarter financial results for 2013-14. (See Box 3.1 for a technical specification of the methodology). The data therefore constitutes a cross-section of board deliberations of all banks at a particular point in time, not a time-series representation of certain chosen banks. The cross-sectional approach has the advantage of eliciting differences in board deliberation, though the period chosen may not be representative of discussions held more generally, and may camouflage the pattern of changes occurring over time. This limitation needs to be recognised. Further, an individual board agenda note may table multiple issues for discussion, and an attempt has been made to separately identify these issues. (For instance, a single agenda note may table both NPAs and restructured assets, which would constitute two issues. It may similarly table the growth of fixed deposits and CASA deposits, again classified as two issues).[8] In addition, some issues may be discussed in detail while others may receive summary attention, and board minutes have been examined to glean an understanding of whether deliberations have been detailed or not. Thereby the attempt is to understand

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[8] By breaking down agenda notes into separate issues, an initial step is taken in capturing the richness of discussion within the board. Clearly, judgment has been exercised on the manner in which issues were identified, and there could be other ways in which this could be done.

differences between banks in the matters tabled, to focus on granular issues raised and to ascertain which of the issues are deliberated in detail.

Box 3.1: The methodology for analysis of board deliberations

The data was coded according to the content-analysis methodology (Krippendorff, 2004;[9] Lieblich et al., 1998)[10]. The content analysis methodology is a "systematic replicable technique for compressing many words of text into fewer content categories, based on explicit rules of coding" (Stemler, 2001).[11] This methodology involves constructing a quantitative database by categorising or coding different aspects of a qualitative data set. The coding was applied to about 3,500 documents across all scheduled commercial banks.

The coding was undertaken in two steps. First, because the coding guidelines required a comprehensive understanding of the content of the meetings, for a small sample of banks, which included public sector and private sector banks, all the board papers were read manually. A distinction was made between agenda notes and items for discussion and the focus was on analysing the items tabled and deliberated rather than mere agenda notes. Second, based on the coding scheme fine-tuned in the first step, computer-based text analysis of the documents for all the banks was undertaken. From the analysis in the first step, keywords and key phrases were identified and these were searched in the second step.

The dynamic of boards is complex, and plays out differently across firms depending on a variety of factors, including the personalities and skills of the Chairman, CEO and other directors, the degree of collaboration between them, the skills and independence they bring to their boards, the nature of the strategic challenges facing the institution, and its positioning in the market. A purely data-driven analysis cannot capture and do justice to this dynamic. It can however throw light on the nature of issues discussed and, through aggregation, enable a comparison to be made (where statistical biases may not be significant) between public sector and private sector banks. It is this comparison that is at the heart of this Chapter.[12]

[9] Krippendorff, K., 2004. Content-analysis: An Introduction to Its Methodology. Sage Publications, Thousand Oaks, CA.

[10] Lieblich, A., Tuval-Mashiach, R., Zilber, T., 1998. Narrative Research: Reading, Analysis, and Interpretation. Sage Publications, Thousand Oaks, CA.

[11] Stemler, S., 2001. An overview of content analysis. Practical Assessment, Research and Evaluation 7.

[12] There could of course also be a conscious decision of the board not to minute certain discussions in detail, and minutes would then not be reflective of the discussion. Similarly, there often are discussions outside of the board which would not be minuted. Another approach therefore could have used surveys or interviews to elicit the richness of deliberations. This would need to rely on board directors' recollection of the content of board deliberations and their willingness to disclose their own responses within the board, which could be fraught with uncertainty and possible bias.

3.2 Comparing Board Discussion in Public Sector and Private Sector Banks

There are seven critical themes which bank boards are typically concerned with: business strategy, risk mitigation, financial reports and their integrity, compliance, customer protection, financial inclusion, and human resource related issues. Table 3.1 provides a more detailed description of matters discussed under these seven critical themes. There are other important matters too which concern bank boards, such as operations. But it is arguable that asserting the competitive positioning of a public sector bank appears to require its board to provide greater focus on the seven critical themes listed.

Category	Description
Business Strategy	Bank and business strategy; development of new products; competitiveness of individual businesses; business reviews in relation to targets.
Risk	Policies concerning credit, operational, market, liquidity risks; assessing the independence of the risk function.
Financial Reports and their integrity	Detailed scrutiny of quarterly and annual financial results; NPA management and reported NPA and provisioning integrity.
Compliance	Regulatory requirements; adherence to RBI and SEBI norms; observations from the annual financial inspection by RBI, and from the Long Form Audit Report; review of decisions in previous minutes of meetings, and key decisions within subsidiaries; review of action taken reports; appointments to board committees.
Customer Protection	Mis-selling, particularly third-party products; laying down the appropriateness of products to different customer segments; understanding the broad trends and concentration in the growth of customer grievances and their resolution.
Financial Inclusion	Review of priority sector lending; payments for the disadvantaged; deposit mobilization from weaker sections; support to microfinance institutions; and other issues.

Human Resources	Appointments and approvals of directors, perks and perquisites for employees, incentive schemes for employees, promotion policies for employees, training and skill development of employees.

Table 3.1: Critical themes in board deliberations

By categorising the issues contained in board notes into these seven themes (together with an eighth residual 'other themes' category), several inferences can be made. Figure 3.1 depicts the average number of issues tabled by public sector and private sector bank boards across each of these seven themes. Private sector banks appear to table a larger number of issues across all categories. Further, the focus on risk, business strategy, financial inclusion and customer protection appears weak in public sector banks. Finally, public sector banks (despite their Government ownership) appear to focus less on financial inclusion than their private sector peers.

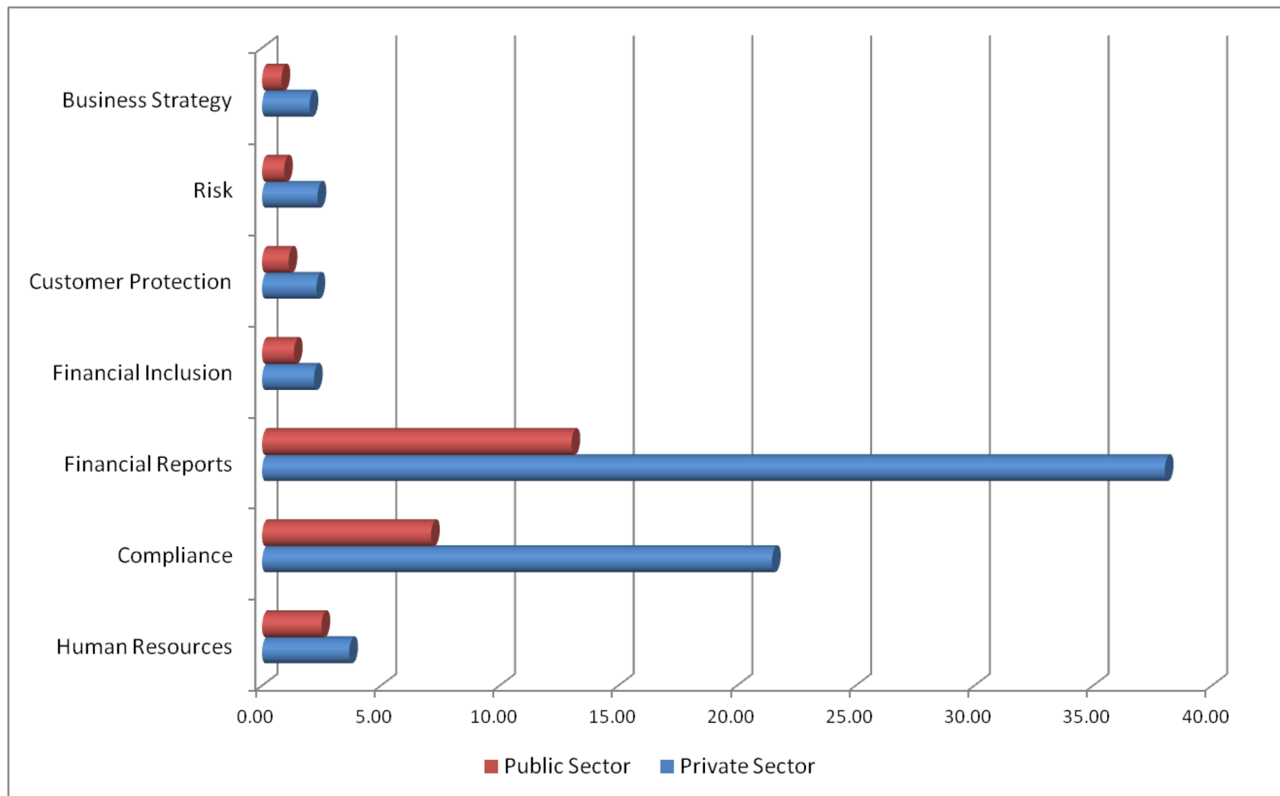


Figure 3.1: Average number of issues tabled

For banks, business strategy and risk mitigation are particularly crucial, and in terms of data furnished by the banks it appears that in both private sector and public sector bank boards there is (on average) inadequate focus on these compared to other issues. On average, both in private sector and public sector bank boards only 6 per cent of the issues tabled include those pertaining to business strategy and risk mitigation though private sector bank boards do

somewhat better with respect to the number of issues tabled in these two categories. Because they are so highly leveraged, banks (more than non-financial enterprises) need to synchronise their focus on these two themes, with the balance between them varying in different phases of the business cycle. In business cycle downturns, particularly, risk mitigation also needs to be watchful of tail risks which could imperil bank solvency.

Issues deliberated in detail, as assessed on the basis of elaboration and nuance as brought out in the meeting minutes, have also been similarly categorised across themes in Figure 3.2. The divide between private and public sector banks is similar, with the former discussing a larger number of issues in each of the seven themes. On both financial reporting and compliance, private sector banks discuss in detail three times the number of issues that public sector banks do, though the focus on business strategy and risk mitigation across both ownership segments of the banking system is (on average) disappointingly low. As a percentage of the total number of issues deliberated, 14 per cent of the issues deliberated by public sector banks include those pertaining to business strategy and risk mitigation while this proportion equals 10 per cent for the private sector banks. Even though this percentage is higher for public sector banks, the same is only due to lower number of issues being deliberated across all categories. Statistical tests also indicate that the scores for the quality of board deliberations across individual banks also correlate with real outcomes in the banks, as Box 3.2 demonstrates.

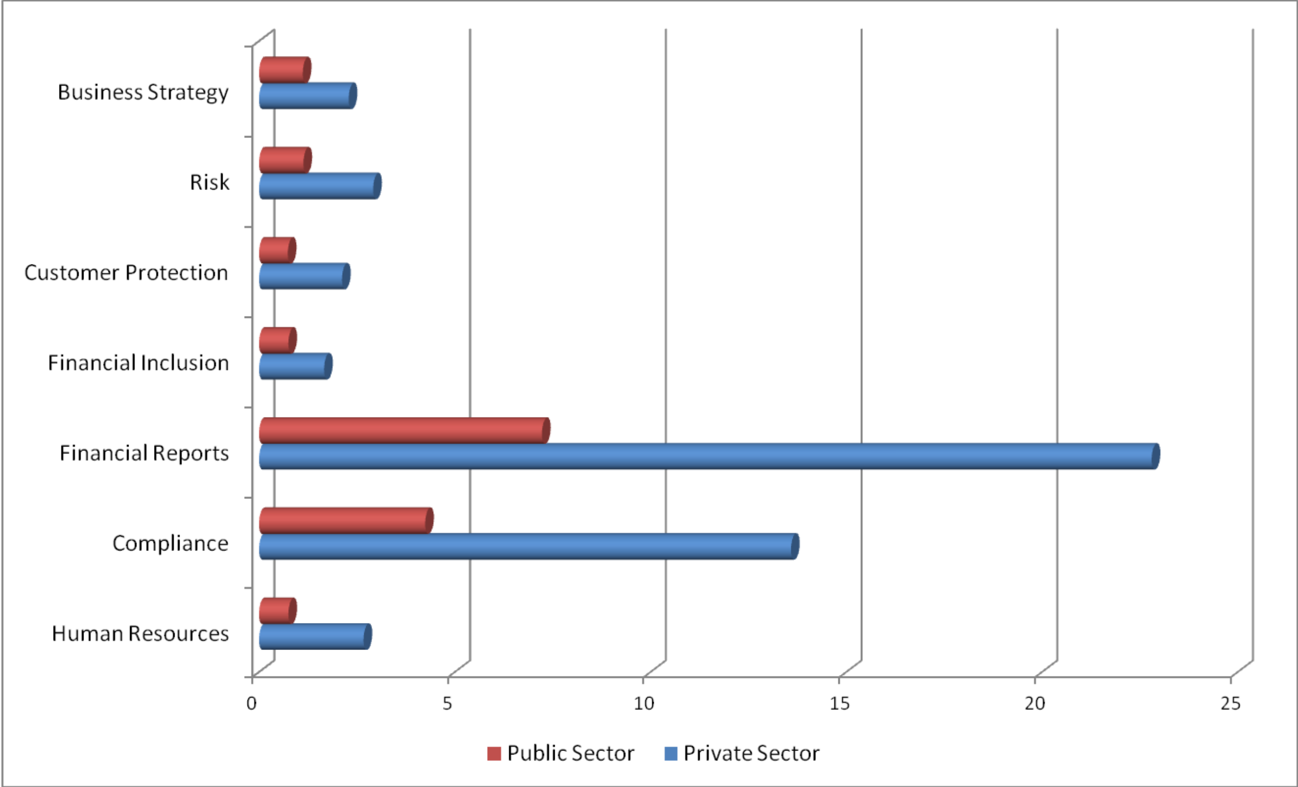
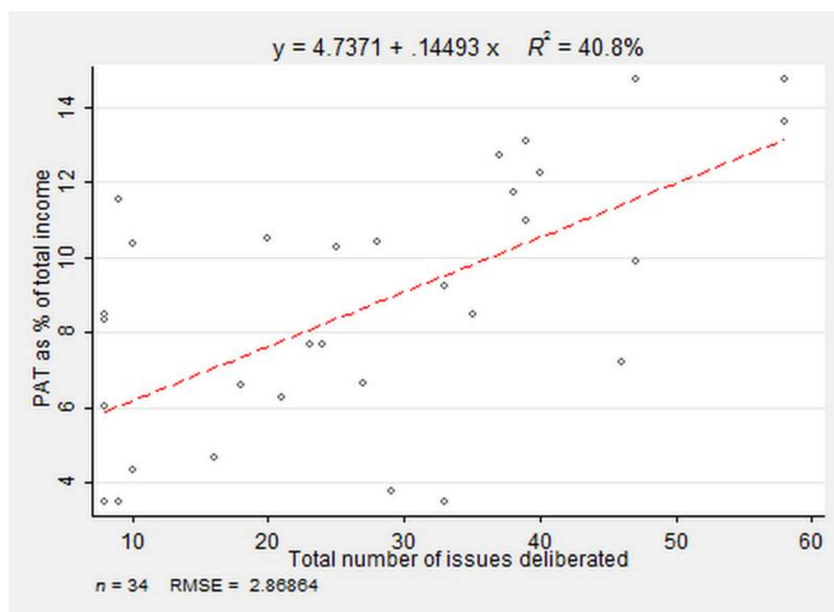


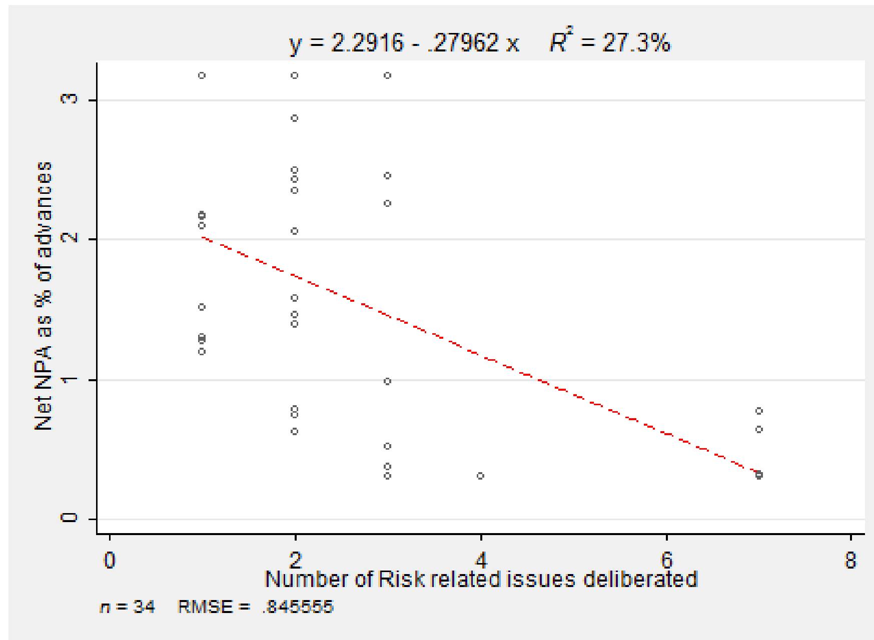
Figure 3.2: Average number of issues deliberated in detail

Box 3.2: Correlation of extent of board deliberations with banks' real outcomes

The total number of issues discussed is positively correlated with bank profitability, while the number of risk-related issues discussed is negatively correlated with net NPAs as a percentage of advances, as the two graphs alongside demonstrate. Similarly, the number of business strategy related issues also correlates positively with the bank's return on assets. All the coefficient estimates for the slopes are statistically significant at the 99% level of confidence. Of course, these correlations do not imply causation and therefore must be interpreted with the necessary caveats.



Notes for the graph: The y-axis plots PAT and the percentage of total income for banks in the quarter ended December 2013 while the x-axis plots the total number of issues deliberated in the board meetings following the announcement of the September 2013 quarter results. Statistical tests reveal with 99% level of confidence that the coefficient estimates for the intercept and the slope are positive.



Notes for the graph: The y-axis plots net NPA as a percentage of advances for banks in the quarter ending December 2013 while the x-axis plots the total number of risk-related issues deliberated in the board meetings following the announcement of the September 2013 quarter results. Statistical tests reveal with 99% level of confidence that the coefficient estimates for the intercept and the slope are positive and negative respectively.

The low focus on issues relating to business strategy and risk mitigation leads to the following Recommendation:

Recommendation 3.1: *There is a need to upgrade the quality of board deliberation in public sector banks to provide greater strategic focus. There are seven themes which appear critical to their medium-term strengths comprising Business Strategy, Financial Reports and their Integrity, Risk, Compliance, Customer Protection, Financial Inclusion and Human Resources. All other items for discussion should be brought to the Boards by exception and should typically be discussed in committees of boards. Among the seven themes identified for detailed board scrutiny, a predominant emphasis needs to be provided to Business Strategy and Risk.*

Issues can also be classified as routine and non-routine. Routine issues are customary issues (such as a review of a report by the audit committee). Some routine functions are also mandated by law (such as a review and approval of quarterly financial results). Non-routine issues are one-time special issues to be deliberated (such as the guidelines issued in 2013-14 on the restructuring of assets). Figure 3.3 reveals that private sector bank boards appear to deliberate a larger number of issues of both a routine and a non-routine nature.

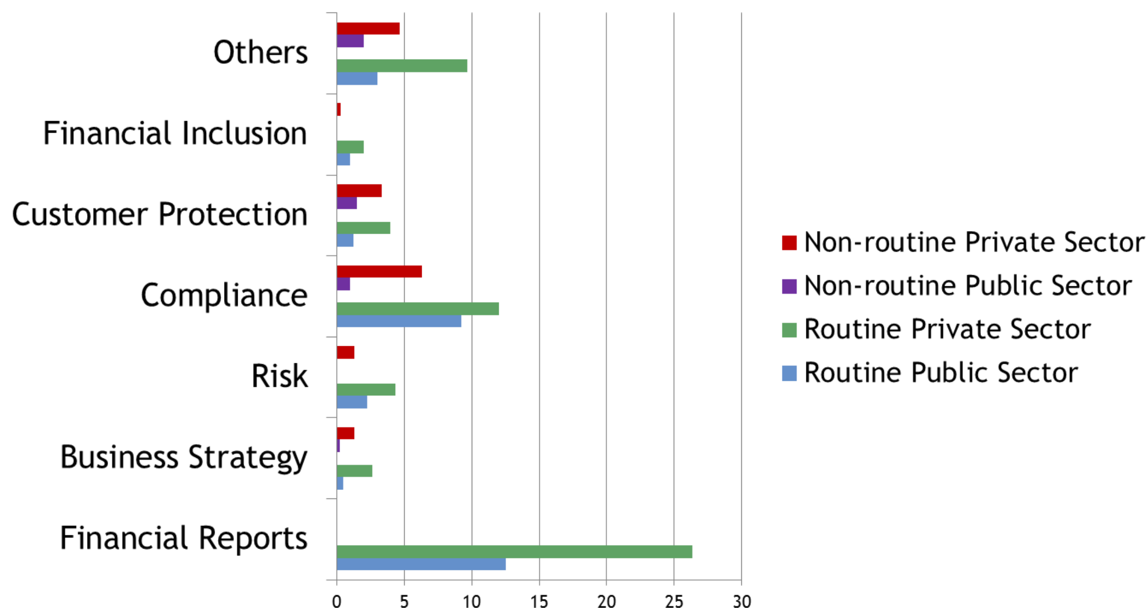


Figure 3.3: Category-wise comparison of Routine vs Non-routine Issues

3.3 Strategic vs. Tactical Focus

A detailed scrutiny of board notes suggests that public sector bank boards focus inadequately on discussing long-term strategy.[13] The focus is more tactical and less strategic, such as the location of branches and ATMs. Moreover, the deliberations are driven from the vantage-point of compliance rather than business economics. There is generally weak evidence of the monitoring of measurable disaggregated business goals in relation to targets. In one bank the taxi fare reimbursement policy gets the same coverage as the NPA recovery policy. Other non-strategic issues discussed include purchase of office premises at Bhopal and provision of leased residential accommodation to officers in six locations (their inclusion in board deliberation - absent in private sector banks - probably reflecting vigilance enforcement concerns). Other

[13] Though, as Figures 3.1 and 3.2 indicate, the position is only marginally better in private sector banks. Notwithstanding this, in two banks, one each in the public and private sectors, the level of discussion on strategic issues is impressive. In the private sector bank, the CEO presents an analysis of the challenges inherent in the near-term outlook, measures taken to cope with recent macroeconomic challenges, review of financial performance, business strategy, risk and the development of talent. The focus is on substance rather than form. In the public sector bank, the discussion begins with a performance review, the fall in CASA deposits, and the rise in NPAs and provisions. A detailed discussion follows on risk, followed by business strategy, capital raising and new business plans. However, the agenda does eventually get dominated by a number of tactical issues, suggesting that even public sector bank boards where discussion quality is impressive are unable to free themselves of these tactical issues, unlike the better bank boards in the private sector.

non-strategic issues discussed include the details of a lecture by a bank's CMD at a college; extensive coverage of the Finance Minister's visit to the bank; and discussion of disciplinary action against manager-level employees.

Amongst areas of recent concern in public sector banks is the worsening of asset quality, and yet there is a general absence of a calibrated discussion in boards of the sectors within which the greatest stress has emerged, and implications this might have for further loan growth in those sectors. Recoveries through the Debt Recovery Tribunals and under SARFAESI are inadequately discussed, and progress in bringing stressed assets back to health are also insufficiently analysed. The worsening asset quality in recent quarters in the public sector banks ought to have led to a substantially deeper analysis of the bad debts problem, but there is weak evidence of this. This is of course an example of how risk mitigation is addressed by boards. Scenario analysis through stress-testing is absent, and specific plans for meeting worst case scenarios find no mention. It is possible of course that other meetings of the boards have been more focussed on these issues, but in the cross-section of board papers analysed there was little attention devoted to the design of risk mitigation mechanisms, including whether the risk function should be invested with greater autonomy, including in matters of credit risk.

There are limits to the ability of regulation and supervision to upgrade the quality of board deliberations, even though the RBI supervisory process attempts to evaluate such quality during banks' Annual Financial Inspections. There is a need for boards to be empowered with strategic and domain skills and with independence, before we can expect the quality of board deliberations to become more strategic. The discussion leads to the following Recommendation:

<u>Recommendation 3.2</u>: *As the quality of board deliberation across firms is sensitive to the skills and independence of board members, it is imperative to upgrade these skills in boards of public sector banks by reconfiguring the entire appointments process for boards. Otherwise it is unlikely that these boards will be empowered and effective. Specific recommendations for this purpose are separately made in this report.*

3.4 Calendar of Reviews

RBI prescribes a Calendar of Reviews detailing the subjects that need to be discussed in boards and board committees, and their frequency. This was initially prescribed for public sector banks in 1984 by the Government of India, and periodically revised, then extended by RBI to the private sector banks. Presently there are 21 items which need mandatorily to be brought to each bank board, of which 12 are to be discussed in every meeting. In 2013 an internal RBI

working group proposed modifications in the calendar and sought the Government's approval for these changes, but this has not been implemented.

If banks are to find the time and commitment to discussing strategic issues, such a calendar of reviews would need radical modification, possibly a revocation. It motivates the following Recommendation:

Recommendation 3.3**:** *The Calendar of Reviews needs either to be revoked, or else to be freshly designed so as to ensure that the time of the board is spent largely on the seven critical themes listed in Recommendation 3.1, with specific attention given to business strategy and risk management.*

Chapter 4

The Control of Public Sector Banks

4.1 Types of Control

Although public sector banks exist in several countries, the style of Government control varies widely. There are diverse ways of characterising these styles, and a useful starting point is to define them in terms of three different roles which the Government might play, with implications for the empowerment of bank boards.

1. Government-as-Investor: In this role the Government is focused only on maximising, or else reaching a threshold level of, its return on equity in the bank each year. Its preoccupation is therefore solely on financial returns, and it adopts a perspective of maximising shareholder value, which thereby protects the interests of taxpayers. The oversight of management and the governance of the bank are entrusted to the bank's board of directors, which is fully empowered in running the bank.

2. Government-as-Owner: In this role a wider set of responsibilities in the running of the bank is assumed by the Government, and the management of the bank is thereby shared between the Government and the bank's board. Illustratively, the appointment of the bank's Chairman and CEO (in India, these have hitherto been combined in public sector banks), the standardisation of procedures on recruitment and promotion of bank personnel, the stipulation of employee compensation, and the manner of enforcing vigilance on employee integrity, are examples. Bank boards are then less empowered, losing autonomy over certain key decisions in steering the bank's strategy. The Government's role also raises delicate issues about protecting the interests of minority shareholders who, in voting for board members in shareholder meetings, expect them to provide full management oversight and own responsibility for the performance of their banks.

3. Government-as-Sovereign: In this role the bank becomes an instrument for achieving a wider set of objectives of state policy. These objectives encompass social welfare goals, specific objectives of financial inclusion and the conscious deepening of specified product markets. We term these as development goals. In addition, and partly to achieve these development goals, the Government also issues additional regulations applicable to its public sector banks. The boards of these banks are consequently much more weakly empowered, and the banks have to contend with dual regulation and to subserve development objectives, which puts them at a competitive disadvantage with banks in the private sector. This style of controlling banks also typically leads to widespread suasion from different arms of the Government.

It is worth observing that the only role where the objective for the bank is clearly laid out is the first one, in the context of Government-as-Investor. In the other two roles, the objective becomes progressively fuzzier. It would be reasonable to expect financial performance to also regress and

worsen as the role transitions from Investor to Owner to Sovereign. Further, whereas Government-as-Investor represents an easily identifiable governance structure, wherein all management decisions are within the purview of the bank board, the other two roles could vary in terms of the precise autonomy and empowerment residually left for the bank board by the Government.

4.2 Varieties of Control - Some Examples

There are examples across countries of governments playing each of the three roles in respect of banks they control, and each represents a style of governance and management of the bank. Concrete examples given below illustrate both the diverse histories in which governments have adopted particular roles, and provide pointers to the manner in which a choice for India could be made.

1. Government-as-Investor:

(a). The Singapore Government controls DBS through Temasek. The board of DBS is fully empowered. For example, before the present CEO of DBS was appointed, a search committee was appointed and coordinated by the board of the bank. Neither the Singapore Government nor Temasek had a role in this.

(b). The UK Government controls RBS and Lloyds Bank through the UK Financial Investments Ltd (UKFI). UKFI was set up in the context of the government bail-out extended to these two troubled banks after the 2008 financial crisis, and the UK Treasury is its sole shareholder. The boards of both banks are subject to standard corporate law directors' duties, and fully empowered. UKFI is viewed as a buffer between the banks and politicians, and acts as an informed shareholder.[14]

(c). The Government of Belgium controls Fortis and Dexia, two troubled banks, through SPFI-FPIM, a holding company. The latter pursues a proactive investment policy with a view to maximising long-term financial returns. Here too, the boards of the two banks are fully empowered to govern and manage the banks.

In each case, the role of Government-as-Investor is discharged through the construct of an intermediate investment company, seen as beneficial for both profitable and stressed banks.[15]

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[14] UKFI has signed a (revised) shareholder relationship agreement in 2010 with the UK Government containing three 'overarching objectives': maximising sustainable value for the taxpayer, taking account of risk; maintaining financial stability; and promoting competition. UFKI's mandate should therefore be seen as maximising medium-term taxpayer returns adjusted for risk, subject to the maintenance of financial stability and competition. Its mandate also includes eventually disinvesting from the two banks.

[15] The investment or holding company for the ownership of government banks is widespread, including in China. Prominent exceptions, in the form of direct holdings by governments, are to be found in Germany, Indonesia, Brazil and India.

2. Government-as-Owner:

(a). The Government of Brazil controls Banco do Brazil. It owns 59 per cent of the bank, held directly and without an intermediate holding company. The CEO is appointed by the Brazilian President, which diminishes the bank board's powers. Candidates applying to work in the bank need to pass a competitive examination similar to what is applicable to Government officers, further disempowering the bank's board in the manner in which it sets recruitment policy.

(b). The Government of Brazil also controls Caixa, which the Government fully owns and in which it appoints all directors. Caixa is a special purpose bank serving as a tool for public investment and expansion of public access to financial services. As the developmental role is confined to wider objectives within financial services, the role is closer to Government-as-Investor rather than Government-as-Sovereign, though it also embodies some characteristics of the latter.

3. Government-as-Sovereign:

The Government of China controls China's four largest banks, Industrial & Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China, through an investment company, Central Huijin Investment Ltd. These banks represent the Government's instruments for furthering state policy. The Government appoints the bank Chairmen and Presidents, typically members of the Chinese Communist Party. Directed credit is very evident in these banks' lending, and periodic financial stress has necessitated recapitalisation by the Government.[16]

4.3 How should the Government of India control Public Sector Banks?

Several decades of running its banks in a Government-as-Sovereign role has (as Chapter 2 demonstrated) resulted in acute financial stress for banks, falling market share, increasing evidence of uncompetitiveness in relation to the new private sector banks, deeply negative financial returns for the Government, and the prospect at the present juncture of a capital injection into banks which could threaten the Government's fiscal consolidation.[17] It has also led to bank boards getting disempowered. Despite its many historical benefits of expanding the reach of the banking sector, it is difficult to argue today that the Government's style of running its banks is serving either the Government or the banks well. In addition, this style of controlling banks also leads to suasion, wherein several arms of the Government issue informal oral instructions or

[16] In all China has 620 government owned banks, though the 'big four' dominate. Other categories of banks include 'policy banks', tasked with financing economic and trade development, second tier commercial banks and city commercial banks.

[17] As the Government does not trade in its stock of bank shares, it makes no capital gains unlike other investors. Its profit is therefore just the 'carry', which is deeply negative as it represents the difference between the dividend yield on its investment (estimated at 2-3 per cent in the last decade) and the interest paid out on government bonds invested in by banks (over 8 per cent). Government has mandated that capital invested by it in banks should in turn be reinvested by the banks in government bonds, making the transaction liquidity-neutral for the Government.

proffer advice which may never be put on official record. It is thereby very easy for such a style of control to deeply politicise bank governance. When such suasion also extends to loan sanctions, often at the behest of corporates and other borrowers, and spawns an informal profession of intermediaries hawking loan proposals to banks, the banking industry becomes deeply imperiled. Banks then get viewed as an extension of the fiscal arm of the Government rather than as purveyors of good quality credit. Government-as-Sovereign is a style of control that urgently needs to change.

There is now extensive research and documentation on the political nature of lending. It has been argued, for instance, that bank lending by public sector banks tracks the state-level (and not the central-level) electoral cycle, and that targeted lending is particularly high in swing districts where the previous election was won by a small majority.[18] Clearly, such politically induced lending fails to increase production but aggravates loan delinquency.

In searching for alternative styles of control to adopt, it is helpful to note the example of Axis Bank. When this Bank commenced business it was owned by UTI and a clutch of public sector insurance companies. Ownership was one hundred per cent in the public sector, and yet it was awarded a private sector bank license.[19] Even after the bank was listed in 1998, it continued with a majority public sector shareholding, right upto February 2003, when the UTI shareholding was transferred to the Special Undertaking of the Unit Trust of India (SUUTI). Since then, the Government-as-Investor stance has characterised the control of the Bank, with SUUTI acting as a special purpose vehicle holding the investment on behalf of the Government. The CEO is appointed by the bank's board, and because the bank was licensed in the private sector, it sets its own employee compensation, ensures its own vigilance enforcement (rather than being under the jurisdiction of the Central Vigilance Commission), and is not subject to the Right to Information Act. SUUTI appoints the non-executive Chairman and upto two directors on the Board, and there is no direct intervention by the Finance Ministry.

In terms of its shareholding the bank was for many years a public sector bank, though it is no longer so. Fortuitously the bank was licensed at the commencement of its business as a private sector bank, and the style of management after SUUTI acquired its shareholding is very much that

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[18] 'Fixing market failures or fixing elections? Agricultural Credit in India' by Shawn Cole, *American Economic Journal (Applied Economics)*, 2008. The paper demonstrates that in districts where the margin of victory for the state-level incumbent party in the previous election was very narrow, directed lending by public sector banks in the election year increases by 9 per cent compared to any of the earlier four years, and that the difference is statistically significant at the 95 per cent confidence level. In contrast the difference for private sector banks is not statistically significant. Evidence for such politically induced lending by government banks comes also from other countries: For Pakistan (A.L. Khwaja and A. Mian, 'Do lenders favour politically connected firms? Rent provision in an emerging financial market', *Quarterly Journal of Economics*, 2005), for Brazil (D.R. Carvalho, 'The real effects of government-owned banks: Evidence from an emerging market', *Journal of Finance*, 2013) and for 43 countries including India (S. Dinc, ' Politicians and banks: Political influences on government-owned banks in emerging markets', *Journal of Financial Economics*, 2005).

[19] It appears that a private sector bank is what is deemed to be one by RBI, even if the owners of the bank are government entities. Another bank licensed in the mid-1990s, IDBI Bank, was similar, though eventually the bank and its principal shareholder, IDBI, then a development financial institution, merged to form a public sector bank, also named IDBI Bank.

of Government-as-Investor. In the 11 year period March 2003 to March 2014, the share price has risen 32 times. In March 2014 SUUTI sold 9 per cent of the bank's equity stake for Rs 5,550 crores. The Government has done well as an investor.

There is no reason why this theme should not be played out across much of public sector banking, were the style of control to move from the present Government-as-Sovereign to Government-as-Investor. A process for transiting between these roles is proposed later in this Chapter.

India has 27 public sector banks, and this large number differentiates it from most other jurisdictions.[20] This has led to the advocacy that the Government-as-Owner role would be a preferable one, enabling it to assert common standards across banks. There are two independent arguments that are made.

First, it is argued that banks should be treated as public utilities, focusing on channelling financial savings into loans. It is true that banks share some common features with utilities, such as carrying out basic financial intermediation tasks, under an environment of deposit insurance and implicit too-big-to-fail guarantees. However, the analogy ends there. Banking is not a natural monopoly, unlike electricity distribution or urban services; it involves relationship lending specific to each bank-borrower pair which cannot be standardised; it also resorts to inter-temporal smoothing, which benefits borrowers, unlike utilities which seek to optimise in each period by cutting costs; and utilities work in relatively certain environments where market share is not contested, very dissimilar to banking. It is unwise to conceive of banks solely as utilities.

A second argument is one of economies of scope. With 27 banks, a great deal of centrally coordinated standardisation (such as in recruitment, employee compensation, technology absorption and vigilance enforcement) could lower costs for banks, and it is argued that the Government is best positioned to provide such coordination. What the argument misses is that if banks are not to be viewed as utilities, they must be viewed as commercial businesses, the essence of which is differentiation with a view to asserting competitive advantage. Commercial businesses need to work on a whole matrix of talented employee recruitment and incentives, in order to compete successfully in the market place. The standardisation imposed by the Government is inimical to attaining such differentiation and competitive advantage.[21] Some examples of this drive for standardisation are contained in Box 4.1. Private sector banks, in contrast, have been free to innovate on all aspects of their business, subject to regulatory constraints. By imposing a plethora of standardised requirements upon its banks, without achieving economies of scale, the Government has contributed to their homogenisation and has thereby handed over competitive advantage to the private sector banks. The need to exploit

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[20] Only China with 620 and Russia with 46 state owned banks have larger numbers. Within emerging markets, Brazil has 9 government banks, Indonesia has 4 and Thailand has 1.

[21] One of the standardised requirements mandated by the Government is that loan officers should be rotated every three years. In 'Costs of loan officer rotation: Evidence from public sector banks in India', *Working Paper*, Indian School of Business, 2013, K.V. Subramanian, S. Bhowal, and P. Tantri compare the average quality of loans sanctioned during the six months prior to such scheduled transfers with the average quality of loans sanctioned in their final six months by officers subject to unscheduled transfers. They find that the loans in the former group have an 8 per cent higher probability of going bad.

economies of scope (the gains from which could at best be marginal) thus has pernicious unintended consequences.

Box 4.1: Government's direct regulatory interventions

In a directive dated 6th July 2012, the Government issued guidelines to public sector banks on 'Prevention of Asset Liability Management (ALM) risk' on account of excessive deposit-taking by these banks.

These guidelines are wholly regulatory in nature, ought therefore to have been issued by RBI, and by directing them solely at public sector banks they appear discriminatory.

In another circular dated 16 July 2012, the Government instructed the CEOs of all scheduled commercial banks, public sector financial institutions and public sector insurance companies that 'in order to bring about a level playing field, banks may consider uniform card rates for bulk deposits for different maturities at least up to one year across banks… further, all concerned may also be appropriately advised that deviation from the above instructions may be treated as violation of instructions of the government'.

The promotion of such a cartelisation of deposit pricing, extending to institutions within the wider financial system, including those in the private sector, appears injurious to depositor interests and can be viewed as anti-competitive. The circular acts at cross-purposes with the regulatory regime of deregulated interest rates which RBI has established. In effect the Government becomes a second regulator, with little sensitivity to whether its directives are consistent with RBI regulation.

Providing full empowerment to boards of public sector banks can therefore no longer be viewed as one amongst multiple choices available to the Government. It is a precondition to the survival of these banks, to their being able to compete in the marketplace, and to their revival. It is also a precondition for the Government not having to periodically recapitalise its banks with deeply negative returns, with recapitalisation amounts likely to escalate and threaten fiscal consolidation. The discussion above motivates the following Recommendation:

Recommendation 4.1: *The Government needs to move rapidly towards establishing fully empowered boards in public sector banks, solely entrusted with the governance and oversight of the management of the banks. The transition path for this is contained in separate Recommendations.*

4.4 The Advantages of a Bank Investment Company

The discussion earlier has highlighted that several countries, including Singapore, UK and Belgium, have set up intermediate investment companies to hold the equity in banks. This has operationally

distanced the governments from the banks, thereby discouraging direct intervention and suasion, and has helped align the governments' role as that of the principal shareholder in the banks, focused on financial returns. The SUUTI example in relation to Axis Bank is broadly similar.

This is the model India should aspire to, and vigilance is needed to ensure that such a Bank Investment Company (BIC) is not just a bureaucratic layer in an otherwise unchanged style of the Government's control of its banks. Much therefore depends on how the BIC board is constituted, and the empowerment and autonomy conferred on it by the Government. The UK parallel, wherein UKFI signed a shareholder agreement with the Government, in which three 'overarching objectives' of UKFI were specified, is worth adopting, and will provide clarity on BIC's objective. BIC's memorandum and articles would also need to embody this. In addition, it is desirable that the CEO of BIC be a professional banker or a private equity investment professional who has substantial experience of working in financial environments where investment return is the yardstick of performance, and who is appointed through a search process. While BIC would be constituted as a core investment company under RBI registration and regulation, the character of its business would make it resemble a passive sovereign wealth fund. While the non-executive Chairman of BIC would be nominated by the Government, it is highly desirable that all other directors be independent and bring in the requisite banking or investment skills.

The CEO would be tasked with putting together the BIC staff team. BIC employees would be incentivised based on the financial returns the banks deliver. If such incentivisation requires the Government to hold less than 50 per cent of equity in BIC, the Government should do so, and with the right business model it should be feasible to attract non-government investors into BIC. The prime financial beneficiary of moving in this direction will eventually be the Government.

Legislative changes would be needed to facilitate the process of transferring the Government's stake in banks to BIC. In fact, as is argued later, it is desirable to incorporate all public sector banks under the Companies Act, and a repeal of the statutes under which banks are constituted and held is therefore necessary.[22] The legislative changes needed are discussed in Chapter 8.

Another reason, possibly more compelling, for endorsing the repeal of these statutes arises from the need to assert the primacy of company law. With the enactment of the new Companies Act in 2013, India now has a modern and powerful legal governance mechanism for enforcing good standards for company behaviour, including in the governance of company boards. In contrast, the nationalised public sector banks have anachronistic provisions, emanating from the Bank Nationalisation Acts, which govern the functioning of boards as also powers given to the Government as the principal shareholder. Some of these differences are highlighted in Box 4.2.

[22] The Acts requiring repeal are The Banking Companies (Acquisition and Transfer of Undertakings) Acts of 1970 and 1980, The State Bank of India Act, 1955 and The State Bank of India (Subsidiary Banks) Act, 1959. Two public sector banks, IDBI Bank and Bharatiya Mahila Bank, are incorporated under the Companies Act.

Similar observations apply to the State Bank of India Act. Asserting the primacy of the new company law and providing for a level playing field would seem very desirable.[23]

Box 4.2: The Companies Act 2013: A Superior Law for Board Governance

Provisions in the Bank Nationalisation Acts of 1970 and 1980, which relate to the governance of nationalised banks, are anachronistic, drafted in the late 1960s, and have been amended on certain occasions when an equity capital transaction in banks needed to be put through by the Government. The intention appears to have been to lay down a closely-regulated framework for governance of the banks. The provisions of the SBI Act, 1955 and the SBI (Subsidiary Banks) Act, 1959 are similar.

However, the Companies Act, 1956, the legislation that governed corporate governance when the Bank Nationalisation Act of 1970 was passed, has been amended many times before being comprehensively replaced by the Companies Act, 2013. The obligations relating to corporate governance have been made far more stringent in company law – for example, provisions codify directors' duties to the company and stakeholders, and such provisions are justiciable even by way of class action suits, apart from resulting in penalties for bad governance.

On the other hand, the Bank Nationalisation Acts and the schemes made under them are conspicuously silent on liabilities and consequences for bad judgement and decision-making by boards. Instead, the predominant focus in these provisions is either on areas that are well covered under company law and do not therefore need special provisions, or on issues that are distanced from current reality. Examples of the former include provisions governing quorum for a board meeting, frequency of meetings, and the manner of passing circular resolutions. Instances of the latter are seen in provisions that stipulate complex board composition requirements, proportionate representation for non-government minority shareholders, prohibition on payment of bonus to non-workmen, criteria for board membership set out in vague uncertain terms such as "special knowledge" or "practical experience" in areas such as agriculture, co-operation, finance, small scale industry etc. even while currently relevant areas such as financial literacy or expertise in information technology are not even listed.

The Companies Act, 2013 is more concerned with outcomes, and boards risk action if damaged outcomes are a consequence of poor governance. The Bank Nationalisation Acts are more concerned with process issues in the context of boards.

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[23] Many of the provisions in the Bank Nationalisation Acts are anachronistic and a powerful source of governance ills afflicting those banks. For instance, the Acts permit the Government to form 'schemes' applicable to these banks, and thereby intervene in diverse areas such as banks' capital structure, board composition, retirement of directors and the reconstitution, amalgamation and transfer of bank shares. In effect, this intrudes on both regulation (the domain of RBI) and on the law defining organisational behaviour (the domain of company law). The new Companies Act also imposes severe penalties on board directors in the event of misgovernance, which are absent for the nationalised banks under the Nationalisation Acts. These Acts were promulgated to nationalise the banks; in comparison to the new company law they constitute a primitive legal mechanism for governing bank behaviour today.

It needs to be strongly stressed that the full autonomy, empowerment and relevant professionalisation of the BIC board is a prerequisite to the reform and strengthening of India's public sector banks. If this is not achieved in its entirety, or achieved as form and not in substance, or reverts in time to a 'capture' towards the status quo ante, it is then very likely that the process of improving bank governance will falter. The history of the Government's progressive operational interventions and control of the banks over several decades can be undone solely by legal safeguards which empower BIC and protect the banks from direct Government intervention and suasion. The direct obligations of bank staff must be to their CEOs, the obligations of CEOs to their boards, and the obligation of boards to all shareholders including BIC. (In the context of public sector banks, there is a need to assert the rights of minority shareholders, sometimes lost sight of). BIC would have a direct obligation to the Government, consistent with its shareholder agreement, but banks would have no such direct obligation. The stronger the evidence and weight of history on the manner the Government has tightened its operational hold on these banks, the more robust would these safeguards need to be.

The discussion above motivates the following three Recommendations. The elaborateness of the Recommendations reflects the need for safeguards to ensure that the foundational brickwork for BIC is well laid. In its absence, the reform of Government's banks will dissipate and falter.

<u>Recommendation 4.2</u>: *The Government should set up a Bank Investment Company (BIC) to hold equity stakes in banks which are presently held by the Government. BIC should be incorporated under the Companies Act, necessitating the repeal of statutes under which these banks are constituted, and the transfer of powers from the Government to BIC through a suitable shareholder agreement and relevant memorandum and articles of association.*

<u>Recommendation 4.3</u>: *While the Bank Investment Company (BIC) would be constituted as a core investment company under RBI registration and regulation, the character of its business would make it resemble a passive sovereign wealth fund for the Government's banks. The Government and BIC should sign a shareholder agreement which assures BIC of its autonomy and sets its objective in terms of financial returns from the banks it controls. It is also vital that the CEO of BIC is a professional banker or a private equity investment professional who has substantial experience of working in financial environments where investment return is the yardstick of performance, and who is appointed through a search process. While the non-executive Chairman and CEO of BIC would be nominated by the Government, it is highly desirable that all other directors be independent and bring in the requisite banking or investment skills.*

<u>Recommendation 4.4</u>: *The CEO of the Bank Investment Company (BIC) would be tasked with putting together the BIC staff team. BIC employees would be incentivised based on the financial returns that the banks deliver. If such incentivisation requires the Government to hold less than 50 per cent of equity in BIC, the Government should consider doing so, as it will be the prime financial beneficiary of BIC's success.*

4.5 Development Objectives

The discussion earlier highlighted that the Government has periodically issued instructions to public sector banks of both a regulatory and a development nature. Any directions issued which are applicable to a subset of banks do damage to that subset, however laudable the objectives. Those banks not part of the subset are under no obligation to participate; if they do so the participation is voluntary, while for the subset it is coercive. Such discriminatory orders reduce the competitiveness of the subset. It is ironical that the Government seeks to make uncompetitive the very banks it has invested capital in.

All regulatory functions of the Government need to be moved forthwith to RBI, freeing the public sector banks of dual regulation. In addition, it is also discriminatory for development objectives and tasks to be stipulated solely for public sector banks. If the tasks are indeed laudable, they should be laid down for implementation by all banks. The straightforward way of doing so is to route it through RBI.

It will be objected that RBI's role is primarily to regulate, not to foster lending for development. While this advocacy has merit, it must be recognised that very large swathes of lending, in pursuance of development schemes, have for many decades been mediated through RBI. These include lending for financial inclusion through the Priority Sector, and lending for several poverty alleviation programmes. RBI guidelines in this context are applicable to all banks. The distinction between regulation and development can also sometimes be blurred. It can be argued, for instance, that the Statutory Liquidity Reserve which banks need to maintain as a measure of prudence to cover liquidity risk, has grown so egregious over several decades that it is now less a liquidity reserve and more an instrument of fiscal policy, mediated through RBI, and enabling the Government to borrow from the banks. It therefore subserves a development objective, of facilitating the Government's borrowing.

In these ways RBI is already a major conduit for the issuance of guidelines on the support to be provided for the Government's development objectives. Under such circumstances, for the Government to issue other instructions in pursuance of development objectives solely to public sector banks is indefensible. Mediating these instructions through RBI and directing them at all banks makes the impact resemble a tax on banks. Directing them solely at listed public sector banks makes them discriminatory and anti-competitive. It is wise to recognise that as India's competition regulation tightens, such discrimination could attract legal challenge, particularly from minority shareholders.

The discussion above motivates the following Recommendations:

Recommendation 4.5: *The Government should cease to issue any regulatory instructions applicable only to public sector banks, as dual regulation is discriminatory. RBI should be the sole regulator for banks, with regulations continuing to be uniformly applicable to all commercial banks.*

Recommendation 4.6: *The Government should also cease to issue instructions to public sector banks in pursuit of development objectives. Any such instructions should, after consultation with RBI, be issued by that regulator and be applicable to all banks.*

4.6 Mechanisms for Transition

For the Government to realign its role in relation to banks from direct control to indirect control through the Bank Investment Company (BIC), and to further redefine it by transitioning from Government-as-Sovereign to Government-as-Investor, it becomes imperative in tandem to strengthen bank boards with the requisite skills and independence. Board empowerment must lead to sound professional judgment being exercised in the management of the banks. This is clearly a process and not an event, and it is recommended that it be executed in three phases.

Phase 1 would require the Government to move Parliament to enact the legislative amendments needed in order to commence the transition. The legislative thrust would involve repealing the Acts through which public sector banks are set up as statutory bodies, incorporating these banks thereafter under the Companies Act, and transferring their ownership to BIC, with Government initially holding the entire equity in BIC. This phase will also see the constitution of a professional board for BIC. All existing ownership functions presently undertaken in relation to banks get thereby transferred from the Government to BIC. Non-ownership functions, which are a mix of regulatory and development functions, get transferred to RBI. Government-as-Sovereign morphs into Government-as-Owner, and the new role is discharged indirectly through BIC.

Phase 2 commences the process of the reconstitution of bank boards. This process would be undertaken by BIC in consultation with each bank, would identify skill gaps, and bring in the requisite professionals with talent and experience into the bank. The time-lines for these would clearly vary across banks, and BIC's endeavour would be to complete this by Phase 2. BIC continues to exercise bank ownership functions during this Phase.

Phase 3 takes forward the empowerment of bank boards, through the transfer of all ownership functions from BIC to the bank boards. The appointments of independent bank directors, CEOs and other wholetime directors becomes the responsibility of the bank boards, guided by BIC, which would continue to have a limited number (not exceeding two) of nominee directors on each bank board. It would also be desirable in this Phase to split the position of each bank's executive Chairman into a non-executive Chairman (nominated by BIC) and a CEO. In this phase, the Chairman, CEO, other wholetime directors and BIC's nominee directors, would constitute the 'inside directors' who are connected to the bank's principal shareholder (viz. the Government). All other board members would be 'outside directors', and therefore characterised as independent. Clause 49 of SEBI's Listing Guidelines would be scrupulously enforced. Clearly, banks will transition to this at a varying pace, and BIC's role would be to guide and facilitate this in a manner which endeavours to complete this for all banks by the end of this Phase. At that stage the Government-as-Investor characterises the style of control, indirectly exercised through BIC, whose

responsibilities henceforth include raising the financial returns to the Government on its capital invested in banks.

As the non-executive Chairman is not an independent director, a lead independent director could play a helpful role in each bank board during this phase, and would be chosen by the board's independent directors. Such a spokesperson for the independent directors could be a useful counterpoint in the board to the Chairman and the CEO. BIC would help define their role and the manner in which lead directors could be helpful.

This blue-printing of the transition mechanism is clearly not cast in stone, and emphasises that certain tasks need to be accomplished first before other tasks can commence. It is also uncertain how long the three-phase process could take, and the resolve of the Government and RBI would be critical to compressing the period. It might be hasty to compress it into a period of less than two years, and it would be disappointing if it were to take more than three years. What is critical to speedy execution is obtaining the approval of Parliament for the legislative changes proposed. The following detailed Recommendation embodies the transition mechanism:

Recommendation 4.7: *The transfer of the Government holding in banks to the Bank Investment Company (BIC), and the transitioning of powers to bank boards with the intent of fully empowering them, needs to be implemented in phases. The following three-phase transition is recommended:*

> Phase 1*: (a) Legislative amendments enacted to repeal the Acts through which public sector banks have been constituted as statutory bodies, the incorporation of these banks under the Companies Act, and the transfer of their ownership to BIC, with Government initially holding the entire equity in BIC.*
>
> *(b) A professional board constituted for BIC.*
>
> *(c) All existing ownership functions in relation to banks transferred from the Government to BIC.*
>
> *(d) All non-ownership functions, whether of a regulatory or development nature, transferred from the Government to RBI.*
>
> *(e) BIC commences the process of professionalising and empowering bank boards.*
>
> *(f) Ownership functions taken over by BIC from the Government.*
>
> Phase 2*: (g) The reconstitution of bank boards coordinated by BIC.*
>
> *(h) Bank ownership functions continued to be executed by BIC.*
>
> Phase 3*: (i) All ownership functions transferred by BIC to the bank boards. The appointments of independent bank directors and whole-time directors (including the CEO) become the responsibility of bank boards.*
>
> *(j) BIC ensures that each bank splits the position of the bank's Chairman into a non-executive Chairman (nominated by BIC) and a CEO (nominated by the board).*

(k) Strict compliance ensured with Clause 49 of SEBI's Listing Guidelines, which stipulates a minimum number of independent directors. The Chairman, CEO, other wholetime directors and BIC's nominee directors, would constitute the 'inside directors', those connected to the bank's principal shareholder (viz. the Government). All other board members would be 'outside directors', and therefore be characterised as independent.

(l) A lead independent director would be nominated for each bank board by the set of independent directors. BIC would define the role of such directors.

(m) BIC ceases to exercise ownership functions, and morphs instead into exercising investor functions.

(n) Consequently, BIC is tasked with the responsibility of protecting the Government's financial investment in the banks, by raising the financial returns to the Government.

4.7 One License Regime

Although all commercial banks are free to follow broadly similar lines of business, they operate under varied licensing regimes. All public sector banks derive their licenses from statute, with the exception of the recently constituted Bharatiya Mahila Bank, which is incorporated as a company and licensed by RBI. New and old private sector banks, and foreign banks are also licensed separately by RBI.[24]

The oddity of a license not necessarily being congruent with the ownership structure of the bank was discussed earlier in respect of Axis Bank. There are other banks as well which defy ownership logic. Bank of Nainital, despite having a 99 per cent ownership stake from the public sector Bank of Baroda, is classified as an old private sector bank. ING Vysya Bank, despite having a single overseas shareholder, ING, with a 42 per cent stake, is also classified as an old private sector bank. Jammu and Kashmir Bank, despite a majority stake held by the Jammu and Kashmir Government, is likewise classified as an old private sector bank. There are clearly historical reasons for these specific forms of licensing, but from an ownership standpoint they appear illogical. Further, RBI stipulates a differing emoluments cap for the CEO and other whole-time directors for different license categories, so the implications go beyond mere semantics.[25]

These different forms of licensing also encourage and provide a rationale for the dual regulation of public sector banks, which have their own distinctive statute-backed licensing. If the

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[24] Private sector banks are licensed under the Banking Regulation Act, 1949. The statutes governing nationalised banks and SBI, as well as the statute that created the present public sector IDBI Bank (although the bank is incorporated under the Companies Act) expressly exempt these banks from seeking a license from RBI. Dual regulation appears to originate from the very manner in which different categories of banks have been licensed.

[25] Although in 2012 RBI issued a uniform set of regulations to govern the compensation payable to wholetime directors of private sector banks, in practice RBI uses its discretion to approve differential rates of compensation to wholetime directors of banks, based on criteria such as bank size and risk-taking capability. In the process, average compensation for top management in old-private sector banks is significantly lower than in the new banks.

recommendations earlier made are accepted, and all public sector banks are incorporated as companies with the Government's shareholding transferred to BIC, it then becomes feasible to move to a uniform licensing regime for all broad-based banks, with RBI as the sole licensing authority.

Foreign banks incorporated in India would operate under the same license, with the caveat that the lack of reciprocity between India and other regulatory jurisdictions would permit RBI to impose constraints, or even deny licenses, to specific foreign banks. Where no such reciprocity constraints exist, however, a one license policy embracing foreign-owned banks would provide them with national treatment.

The one-license regulatory regime for banks with broad-ranging businesses would also not preclude RBI issuing niche licenses under other, more narrowly defined, licensing regimes, if it were to choose to do so. A discussion paper issued in 2013 by RBI suggests that it is inclined to move in this direction. The following Recommendation follows with the caveats above:

Recommendation 4.8: *It would be desirable for the bank licensing regime to move to a uniform license across all broad-based banks, irrespective of ownership, subject to inter-jurisdictional reciprocity considerations in respect of foreign banks, and niche licenses for banks with more narrowly defined businesses.*

Such a licensing regime would also involve uniform investment limits across investor categories, irrespective of ownership. Other than the Government's own controlling stake all other investment limits recommended for private sector banks in Chapter 6 should also thereby be applicable to public sector banks. This will facilitate larger pools of capital coming into these banks, and assist in improving public sector bank market valuations. For distressed public sector banks, it provides Government with another financing option through the induction of private equity with board representation, a partnership which could also help improve board governance. This leads to the following Recommendation:

Recommendation 4.9: *Other than the Government's own stake, which would be unconstrained, all other investment limits recommended in Chapter 6 for different categories of investors in private sector banks should also be applicable to investors in public sector banks.*

4.8 Further Levelling the Playing Field

Several of the proposals above seek to strengthen public sector bank boards and remove discriminatory external shackles in their ability to compete fairly with their private sector peers. Notwithstanding this there continue to be other constraints which could affect competitiveness. Public sector banks come under the vigilance enforcement ambit of the Central Vigilance Commission; the Government controls employee compensation; and these banks are (in a limited way) subject to the Right to Information Act.

A straightforward way of levelling the playing field in all three matters is to reduce the Government shareholding in banks to less than 50 per cent. Under the proposed BIC structure, this would be achieved by BIC lowering its holding in each bank to less than 50 per cent. The trade-off for the Government involves its accepting a dominant, though minority, shareholding in these banks in return for improving their competitiveness. From a purely financial standpoint this is a favourable trade-off for the Government, as a more competitive set of banks can be expected to improve the financial returns to the Government. There is no effective diminution from a control stand-point either, as the Government would continue to be by far the largest shareholder.

The removal of these restrictions should not be done in haste and should coincide with the emergence of strongly empowered boards. Each bank board would need to assess whether raising employee compensation would also raise productivity and profits, a judgment contingent on several variables.[26] Likewise, each bank board would need to set up a robust internal vigilance enforcement mechanism and organisational structure.[27] BIC could provide helpful guidance in these matters. This is only feasible in Phase 3 of the Transitional Mechanism, and motivates the following Recommendation:

Recommendation 4.10: *It is desirable for the Government to level the playing field for public sector banks in relation to their private sector competitors. Reducing the proposed Bank Investment Company's investment in a bank to less than 50 per cent will free the bank from external vigilance emanating from the Central Vigilance Commission, from the Right to Information Act, and from Government constraints on employee compensation. The trade-off is worth grasping, as more competitive public sector banks will enhance financial returns to the Government with no effective dilution of control. In terms of the transition mechanism proposed, this would be part of Phase 3, and add a 15th step to the 14 steps listed in Recommendation 4.7, as follows:*

> *(o) The Government should consider reducing its holding in banks to less than 50 per cent, in order that there is a restoration of a level playing field for public sector banks in matters of vigilance enforcement, employee compensation and the applicability of the right to information. Vigilance enforcement and compensation policy will thereafter be the responsibility of bank boards.*

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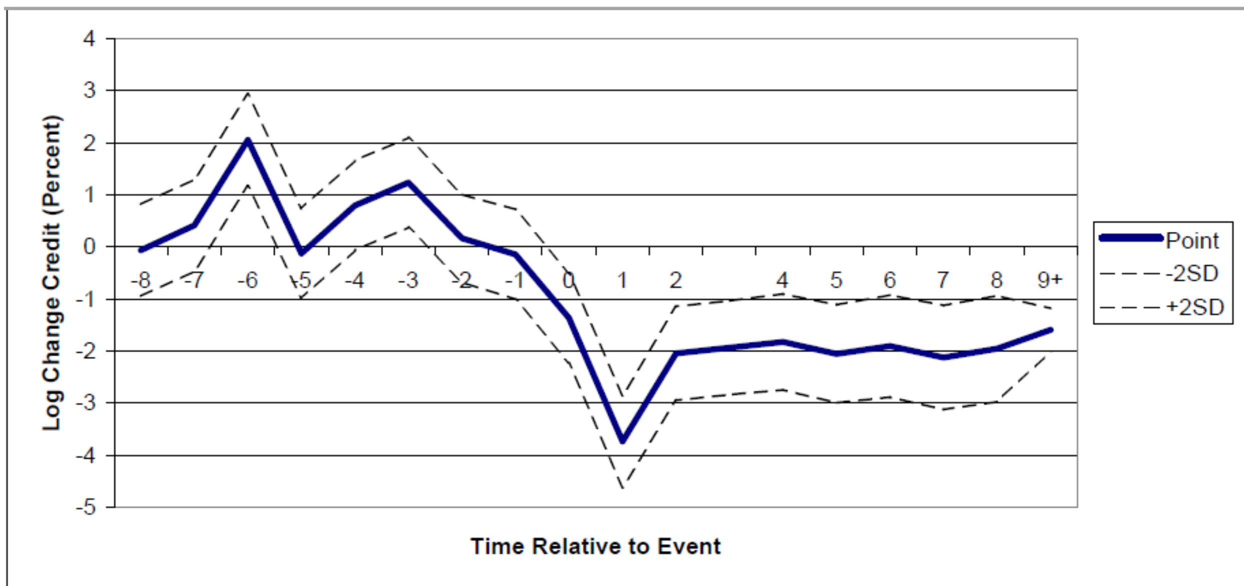
[26] There are major compensation differentials at senior levels of banks. In 2012-13, the average CEO monetary compensation was as follows: For new private sector banks, Rs 3.21 crores (in addition to stock options, whose monetary value is dependent on the bank's stock price); for old private sector banks, Rs 78.63 lakhs; and for public sector banks, Rs 18.66 lakhs. It is unsustainable for such differentials to continue without a major adverse impact on the recruitment and retention of talented managers in public sector banks.

[27] Because internal vigilance enforcement is likely to use more organisation-specific information and assesses employee integrity reputation more accurately, it is argued (in statistical terminology) that in well-functioning organisations it suffers from lower Type 1 and Type 2 errors than does external vigilance enforcement. (Type 1: A dishonest employee remains unidentified; Type 2: An honest employee gets unfairly targeted). Resolution of cases - both enforcement action against the dishonest, and dropping action against the honest - is also argued to be quicker. Research on the impact of external vigilance enforcement on bank lending is disquieting. See Box 4.3 for an example.

Box 4.3: Negative impact of CVC action on lending by public sector banks

'Are the Monitors Over-Monitored? Evidence from Corruption, Vigilance, and Lending in Indian Banks' by A. Banerjee, S. Cole and E. Duflo, *Working Paper*, Harvard Business School, 2007, argues that the lending decisions of loan officers of public sector banks are impacted by fear of prosecution for corruption. The analysis is based on a standard event methodology to assess the impact of actions taken by the Central Vigilance Commission (CVC) on lending. It encompasses all commercial banks in India and covers the period between 1981-2003. The conclusions are striking: Overall lending reduces dramatically in the branches that face CVC action; there is also a contagion effect as lending in branches which are located in close proximity to the affected branch also goes down; unlike many other transitory "shocks", the impact of CVC action on lending is persistent; it takes slightly more than two years from the time of CVC action for lending to recover; and the impact of the consequent loan officer conservatism is predominantly felt by small borrowers, who are traditionally considered by banks as opaque and risky.

The graph below shows for public sector banks the change in credit before and after CVC action, where the x-axis shows the years before and after CVC action, with CVC action occurring in year 0. The dotted lines display the confidence intervals two standard deviations apart on either side of the point estimates represented by the solid line.



Chapter 5

Boards of Public Sector Banks

5.1 Constitution of the Boards

Boards of companies lie at the heart of corporate governance. Good boards are well constituted, believe in and configure strong processes, demonstrate a strong board room ecology which encourages divergent viewpoints with candour, provide effective leadership, are instrumental in deciding CEO succession, and evaluate their members annually. In good boards where these characteristics evolve and strengthen, board governance acts as a spur to the rest of the organisation. In the finest of boards, this heightened governance can be expected to favourably impact company performance.

In public sector banks the board design approach is structural. The Bank Nationalisation Acts of 1970 and 1980 lay down in granular detail the manner in which board positions are to be filled. There are eight broad categories of directors.[28] Similarly, the SBI Act of 1955 refers to seven director categories[29] for SBI, while IDBI Bank (constituted under the Companies Act) has five different director categories. In comparison the new Companies Act of 2013 lays down three categories of directors, though not in a structural manner: executive directors, part-time independent directors and part-time non-independent directors.

The rationale for such a structural approach to board composition must be located historically. When nationalised, these banks were fully owned by the Government and there were no minority shareholders.[30] The corporate governance problem might therefore have been viewed as protecting the interests of the Government as the sole shareholder as against those of bank managements, by stipulating a board composition with varied skills which could keep the bank managements under effective check. With banks now publicly listed with minority shareholders, and with competition from the private sector banks, 'keeping the management in check' can no longer be the predominant governance objective. While historically, at nationalisation, the relationship between bank management and bank owner may not have been fully aligned, today it

[28] These are wholetime directors (the Chairman and Executive Directors); Central Government official directors; directors with expertise in bank regulation and supervision (in common parlance known as RBI directors); workmen employee directors; officer employee directors; chartered accountant directors; Central Government nominee directors; and elected shareholder directors. The chartered accountant directors and Central Government nominee directors are collectively referred to as non-official directors and detailed guidelines have been issued by the Government for their eligibility, mandating that "persons with special academic training or practical experience in the fields of agriculture, rural economy, banking, cooperation, economics, business management, human resources, finance law, marketing, industry and IT will ordinarily be considered."

[29] There is no separate category for chartered accountants.

[30] The category of elected shareholder directors was introduced later, after these banks were publicly listed.

needs to be collaborative to serve the best interests of the owner. The legislatively-mandated structural approach to board nominations is therefore not helpful.

There is also the implicit assumption that board structure influences board conduct and hence bank performance. For this link to be forged, the quality of board directors needs also to be high. Under company law, when boards are constituted by good companies, existing board directors (through the nominations committee) work with the CEO to locate and persuade suitable new directors to join the board. In contrast, in public sector banks all non-official directors are appointed without consultation with bank Chairmen. The probability that this will lead to a constructive board dynamic, wherein the Chairman senses complementary skills in the board and benefits from the advice of the board, must be assessed as low. If some non-official directors are of poor quality or get on to the board with parallel agendas (as is now commonly alleged) the Chairman then begins to view sections of the board as unhelpful to the interests of the bank. The board no longer has a positive dynamic, contributes poorly to the resolution of complex issues, fissures within the board develop, and bank governance suffers.

Such a vicious circle need not play out if, at every stage, the Government is able to refresh bank boards with professionals of high standing and quality. While many professionals of good standing do sit on public sector bank boards, there are several observed facts about the selection process which suggests that the director quality is compromised in Government's appointments. These are discussed in Section 5.6.[31]

5.2 The Appointment of Top Management

The Chairman (who is invariably also the CEO) and the Executive Directors constitute the top management of each public sector bank, and are its whole-time directors on the board. In terms of the existing process for their appointment, a Selection Committee has been constituted by the Government, chaired by the RBI Governor, and including (among others) the RBI Deputy Governor for Banking and the Secretary for Financial Services in the Finance Ministry. In practice, the Governor does not attend the selection process, the Selection Committee comprises a sub-committee chaired by the Secretary for Financial Services, and other members include the RBI Deputy Governor for Banking. The short listing of candidates is undertaken by the Department of Financial Services, with RBI being unaware of how the exercise is conducted. The shortlisted candidates are called for interview, but the interviews are generally short, sometimes lasting less than five minutes for a candidate. Selected candidates need to be appointed through approval of the Appointments Committee of the Cabinet (ACC) of the Government.

Several features stand out about the process specified. There appears to be no search process stipulated, and what has been specified is a selection process. The short listing appears to occur on

[31] RBI had made an earlier attempt at rationalising corporate governance norms for bank boards through the constitution of the Ganguly Committee. See 'Report of the Consultative Group of Directors of Banks/Financial Institutions', RBI, 2002.

the basis of certain demographics associated with the cadre of General Managers in all public sector banks (such as age, number of years of experience as General Manager, etc).

Government officers and regulators may not possess the skills to appoint the top management of commercial banks. Banking is a very specialised activity, and top management needs to combine strategic foresight with a good commercial knowledge of sectors to lend to, prudent risk management and human resource skills. The presently constituted selection committee also lacks close interaction with shortlisted candidates, and the committee assessments must therefore inevitably be superficial. For highly skilled activities, selection by a peer group generally ensures that those who select have the ability and discernment to assess the required attributes. The perception that selection by such a peer group is unnecessary for top management positions in public sector banks fails to recognise the specialised nature of banking and (in the context of government appointments) lends itself more easily to abuse.

In Chapter 4, a three-phase process for empowering the boards of public sector banks was proposed wherein, during Phase 1, a Bank Investment Company (BIC) would be incorporated which would be an intermediate holding company for these banks. The transition process proposed will ensure that In Phase 3 the boards of banks would be fully empowered and therefore, like boards of other companies, would assume full control of top management selections. In Phase 2, this role would be assumed by BIC, which would be appropriately staffed to exercise the role. In both phases an active search process would characterise the selection. How then should this role be exercised in Phase 1, before legislation to activate BIC is passed by Parliament?

The process suggested for Phase 1 is to constitute a Bank Boards Bureau (BBB) which would advise on top bank management selection. BBB will comprise senior or retired commercial bankers, and it is proposed that it should ideally comprise a compact set of three bankers, of whom one would be the Chairman. As this would be a full-time position, serving bank officers would need to resign if chosen. For the process to carry credibility, it is important that the Chairman and members be of high standing and have led banks, and it is recommended that their choice be made by the Government in consultation with RBI. Their remuneration would also need to be at least that of serving senior bank Chairmen. As the appointments to the top management of banks will continue to require the concurrence of ACC, it is desirable that BBB's recommendations be generally accepted by the Government. It should therefore be mandated that BBB should make a public disclosure of all cases of recommendations made which are rejected by the Government.

Thus, even in Phase 1, the appointments process will be handled through peer scrutiny. It would professionalise and depoliticise the process, and is more likely to select the more deserving and competent bankers within the system for top management positions. The legislation to constitute BIC is meant to be passed quickly, keeping BBB's existence brief; but as the speed of such legislative changes is uncertain, it is proposed that members of BBB be given a tenure of three years or until powers are passed on to BIC, whichever is shorter. If the period is three years, there would be no renewal of contract thereafter, thereby ensuring that the independence and autonomy of BBB is not compromised. Further, even after the constitution of BIC, BBB could

continue to act as its advisor on matters of bank board selection. This composite proposal leads to the following two Recommendations:

Recommendation 5.1: *In the context of the three-phase process earlier proposed, it would be desirable to entrust the selection of the top management of public sector banks during Phase 1 to a newly constituted Bank Boards Bureau (BBB). It is recommended that BBB be set up by an executive order of the Government and comprise three senior bankers chosen from among those who are either serving or retired Chairmen of banks, one of whom will be the Chairman of BBB. They would be bankers of high standing and the Government should select them in consultation with RBI. Where selections to top bank managements are proposed by BBB but not accepted by the Government, BBB will make a public disclosure.*

Recommendation 5.2: *The Chairman and each member of BBB should be given a maximum tenure of three years. During this period the transfer of powers to the Bank Investment Company (BIC) is envisaged and upon transfer to the BIC, tenure would cease. There will be no renewal of their contract thereby ensuring that BBB's autonomy and independence is not compromised. Their remuneration would be at least that of existing public sector bank Chairmen.*

5.3 Utilising Talent: The Need for Long Tenures

While the selection process for top bank management will be handled by the Bank Boards Bureau (BBB) in Phase 1, by the Bank Investment Company (BIC) in Phase 2, and by bank boards in Phase 3, there are several changes needed in human resource practices if top management is to successfully steer a bank into greater competitiveness. Presently, bankers get appointed to top management positions a little too late in their careers for them to have adequately long tenures. These top management positions are contractual, and end at the age of 60 or after two years, whichever is later. While some officers do get longer tenures, most do not. It is desirable that Chairmen of banks have minimum five-year tenures, while Executive Directors have three years.

It is also desirable for such a minimum tenure rule to be embedded in a human resource policy which fills top management with younger people. There is a demographic opportunity imminent in these banks created by the large scale retirements which are now expected. It is projected that 60-90 percent of general managers and deputy general managers as at end-March 2014 will have retired by March 2017. This will create a significant senior management vacuum in public sector banks.[32] If personnel policies are poorly architected, this will lead to inexperienced staff rising clumsily into senior management. If however personnel policies are well designed to identify

[32] Recruitment to public sector banks has oscillated over past decades. Significant employee expansion between 1969-84 in pursuance of creating a large branch network was followed by a suspension of fresh recruitment between 1985-2000, with emphasis instead given to officer-level vacancies being filled by promotions from the clerical cadre. Besides the repercussions this might have had on the quality of middle management, the average age of employees rose. Recruitment resumed thereafter, and today these banks have two dominant demographics, those over 50 years old and others under 30. A large proportion of the over-50s will retire by March 2017, requiring intelligent personnel policies to fill the senior management vacuum.

talented people who have demonstrated success who could be groomed for senior management, this could alter the demographic profile of top management with beneficial consequences.[33] With younger people of talent and a successful track record in top management, the minimum tenures would get automatically ensured.[34] It motivates the following Recommendation:

Recommendation 5.3: *It is desirable to ensure a minimum five-year tenure for bank Chairmen and a minimum three year tenure for Executive Directors. Given the very large retirements in senior management positions expected in the next three years, well-designed personnel policies to identify talented people who have demonstrated success would enable them to be groomed for senior management. This could alter the demographic profile of top management with beneficial consequences. With younger people of talent and successful track record in top management, the minimum tenures would get automatically ensured.*

5.4 Skewing the Supply of Talent: Some Consequences of Vigilance Enforcement

Data on vigilance cases reveal that a disproportionate number of managers handling credit face vigilance enquiries.[35]

There is a fundamental and deep irony here: Skills in appraising credit are probably the most critical in the eventual profitability of banks, and yet, because these cases are targeted most actively by vigilance, these skills are in short supply in top management. Several consequences follow:

First, bank officers are now reluctant to handle credit. The procedures for credit approvals underwent a change in 2009 and require all proposals in branches, generally pertaining to retail and other small advances, to be signed off by the branch managers. There is risk-aversion in doing so among honest officers, for fear that vigilance targeting on loan losses could impair their careers. Loan sanctions at the regional or zonal level, or in bank head offices, are approved by committees. Because of this, in theory these officers are less at risk, though in practice this is not always assured as loan losses are higher.

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[33] A comprehensive attempt at identifying human resources issues in public sector banks was undertaken by the Khandelwal Committee, at the instance of the Finance Ministry, Government of India. See 'Report of the Committee on HR Issues of Public Sector Banks', 2010.

[34] Long tenures with younger senior management could also create conditions for the better execution of a consistent medium-term strategy. An indication of the absence of such consistency arises from the manner in which reported earnings fluctuate when shorter tenured CEOs retire and are replaced. K. Subramanian, A. Sarkar and P. Tantri, 'CEO turnover and earnings management in banks: Evidence from public sector banks in India', *Working Paper*, Indian School of Business, Hyderabad, 2014 document that RoA drops by 23 per cent on average in the transition quarter, on account of higher provisioning.

[35] Data compiled by RBI indicates that in 2012-13, 77 per cent of vigilance cases initiated against bank managers were directed at managers handling credit.

Second, a perverse belief then develops in banks wherein those who have not 'soiled their hands with credit' are believed to be very likely to find the easiest path into top management. It is but a short step from such a belief to the more pernicious culture that pervades management thought in these banks, which leads to murmurs that those who avoid personal initiative and discretion are most likely to rise to the top. A policy for identifying, nurturing and developing talented managers gets negated by such a form of vigilance enforcement.

Third, the very nature of credit appraisal then becomes mechanistic, driven by processes stipulated. In private sector banks, judgments in taking prudent credit risks are acquired over time, and modified by outcomes. 'Learning by doing' is a part of gathering experience and skills, and learning from improper judgments exercised in the past eventually assists in developing good credit officers. The best credit officers use discretion innovatively and thereby often deviate from established procedures. In these banks, deviation from procedure does not imply culpability. In contrast, when there are loan losses, in public sector banks culpability is often presumed if there are deviations in procedure.

Fourth, there is no assurance on when a vigilance case, once initiated, would be closed if the enforcement authority were to conclude that the officer is not culpable. Cases drag on for years, with careers permanently damaged and uncertainty about whether and when an officer will face criminal action in courts. Where vigilance enforcement commences just before an officer retires, it becomes part of the officer's retirement reality.

Fifth, and the most damaging, the genuinely corrupt and the honest who have only deviated from procedure are clubbed together, in a manner which must surely delight the former, as they are in good company. Neither the enforcement agency nor the outside world is finally able to tell the corrupt apart from the honest.[36]

There must be a better and a fairer way to identify and proceed against the dishonest, even while protecting the honest. It is helpful to draw from practices elsewhere. In the US, among the most litigious of countries, even in civil liability cases where the burden of proof is weaker than in criminal cases, the 'business judgment rule' governs court decisions.[37] The rule specifies that courts will not review the business decisions of directors who performed their duties (1) in good faith; (2) with the care that an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner the directors reasonably believe to be in the best

[36] Public sector bankers deserve better than to be trapped within such a Kafkaesque world. In Franz Kafka's classic novel, "The Trial", Joseph K wages an individual struggle in vain against pervasive, anonymous forces that determine, yet simultaneously oppose, his every step, and where it becomes impossible to separate truth from illusion in the manner in which 'justice' is sought to be imposed on him.

[37] The business judgment rule refers to a common law presumption that directors act in the best interests of the corporation they serve and that a court will therefore not review the substantive wisdom of directors' business decisions, as otherwise directors would be 'frozen in inaction' if they were to be subject to legal action for decisions which in hindsight were monetarily or otherwise unsuccessful for the corporation. The rule generally requires a clear indication of fraud, gross negligence or self-benefit. Some courts have also ruled that the burden of proof on fraud and gross negligence also rests on demonstrating self-benefit.

interests of the corporation. Civil courts have been widely supportive of this rule.[38] In criminal cases, the standard of proof required for a conviction is even stronger. The main burden of proof rests on demonstrating self-benefit, monetary or otherwise, which thereby demonstrates that an individual abused his loyalty to his organisation by benefiting himself. Criminal cases against individuals too typically stand or fall in courts based on whether self-benefit is demonstrated.

It is desirable that lending decisions by public sector bank officials in India be evaluated on a broadly similar standard of evidence. If there is no evidence of self-benefit, FIRs and charge-sheets should not ordinarily be filed. The present process adopted is to scrutinise all loan cases above a threshold limit where there have been defaults and to identify procedural lapses as the basis for vigilance enforcement action without necessarily obtaining evidence of self-benefit. In Chapter 8 a provision in the legislation is proposed, which thereby protects honest officers, while demanding of enforcement authorities a higher standard of evidence to identify the dishonest.

Such a higher standard of evidence must apply to other forms of bank expenditures as well. Thus, the present process of subjecting every major strategic investment (such as on information technology spending) to automatic vigilance scrutiny based on fidelity to procedure, creates similar risk-aversion among senior managers in being innovative.

The intention is not to understate the extent of corruption in public sector banks - which is a major public policy concern - but instead to suggest that the instruments for identifying and tackling it need to differ, because the burden of evidence needs to be more demanding. As bank boards move into Phase 3 of the transitional mechanism, fully empowered boards would face the onerous obligation of ensuring high levels of integrity amongst bank staff, in the manner many private sector banks strive to do, and internal vigilance would need to be sharpened. The primary criterion for initiating action should however need to be based on self-benefit. If vigilance enforcement is unable to demonstrate self-benefit, but nevertheless brings accusations of corruption against bank managers, it is the enforcement process which requires an upgrade and would need to subject itself to a higher standard of professional scrutiny.[39]

Recommendation 5.4: *Cases of vigilance enforcement against wholetime directors and other bank employees for decisions taken by them must be based on evidence that the director or employee personally made a wrongful gain. For levelling criminal charges, fraud must manifest itself through evidence of self-benefit. In loan and expenditure cases, deviations from procedure must not constitute the sole basis for initiating criminal action.*

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[38] "Mistakes or errors in the exercise of honest business judgment do not subject the officers and directors to liability for negligence in the discharge of their appointed duties." (Otis & Co. vs Pennsylvania R Co., 61 F. Supp. 905).

[39] It has been helpful that CVC has constituted an advisory board, chaired by a former RBI Deputy Governor, to which cases get referred for advice whenever CBI and banks disagree about whether vigilance enquiries should be launched.

5.5 The Continuance of Talent: Succession Planning

Present processes for filling vacancies in public sector banks leave several top positions vacant after incumbents have retired. With their gaze more strongly directed at retirement dates, the Bank Boards Bureau (BBB) in Phase 1, the Bank Investment Company in Phase 2 and the bank boards in Phase 3 can be expected to make selections well in time. These selections would require the approval of the Appointments Committee of the Cabinet (ACC) as long as the Government holds a majority stake in the banks. There is however one significant constraint in making these appointments.

When candidates are presently shortlisted for top bank positions, a clearance is sought from the Central Vigilance Commission (CVC). Where it is given, the candidates are interviewed. If selected, a new phenomenon appears to surround and afflict the appointments process - a flurry of anonymous complaints to the Government against many of the applicants. Before the appointments are sent for ACC clearance, therefore, these complaints need to be examined by CVC, and, in effect, a second round of vigilance clearance commences. As every anonymous petition has to be examined for its veracity, this takes time, and the appointments get delayed.

The question needs to be posed about why this flurry of complaints picks up steam only after the Selection Committee has completed its task, and not earlier. The grapevine is generally sceptical that these allegations are well-founded. It appears desirable that, after selection, all allegations be ignored.

Succession planning is a more composite exercise than merely filling up vacancies on time. The new institutional mechanisms proposed in this Report, of BBB and BIC, should prove more focused towards attempting this exercise. In Phase 3, empowered boards can be expected to achieve this more fully.

The discussion above leads to the following Recommendation:

Recommendation 5.5: *It is feasible and vital that in Phases 1-3 the selection process is initiated in good time to complete the appointments approval before the expiry of tenures of the incumbents. Delays presently occur because of vigilance clearance. It is recommended that this clearance be conducted only at the stage when candidates are short-listed, and not resumed after the Selection Committee recommends the candidate for appointment.*

5.6 Contrasting Signals

Section 5.1 discussed briefly the different ways in which public sector and private sector bank boards differ, and it is helpful to further emphasise this contrast. First, the historical legacy of the Bank Nationalisation Acts governing appointments to public sector banks leads to a structuralist approach of defining narrow professional careers as the determinant of board qualification; in contrast, company law provides greater flexibility in bringing the right skills on to private sector

bank boards. Thus, while the Government seeks the professionally qualified for board positions, new private sector banks, and increasingly old private sector banks, search for the professionally talented, preferably of high standing. The distinction is material: for instance, almost all chartered accountants would qualify for appointment to public sector bank boards, but a very small subset would be sought after by the private sector bank boards. Second, that this freedom is generally not abused by private sector bank boards - though there could always be exceptions - derives from the way the CEO and existing directors collaborate to bring new directors in, while in public sector banks all non-official directors are externally imposed on boards without any consultation with the bank Chairmen. Third, private sector banks have a large proportion of independent directors in compliance with Clause 49 of the stock exchange listing requirements, while in public sector banks, other than elected shareholder directors, all other directors are nominated by the Government (and one by RBI) and cannot be construed as independent. This is an egregious violation of Clause 49. Sadly, even the elected shareholder directors generally owe their election to LIC, given LIC's dominance as a shareholder in most banks, and the perception is widespread that LIC's support is best 'managed through the Government'.[40] Therefore, in effect, there appears to be no independent director on public sector bank boards. Fifth, while private sector bank boards need to conduct a 'fit and proper' assessment for incoming directors, public sector bank boards make no such assessment for their incoming non-official directors, as they are appointed by the Government. Sixth, and most damaging, this signals the contrasting nature of boards in public sector and private sector banks: the one imposing boards on banks with suspicions of directors owing political allegiance, and appointments being made without consultation with Chairmen;[41] the other more collegiate, attempting to bring complementary skills on to boards, assisting the CEOs in the articulation of business strategy, and involved in succession planning.[42] And seventh, with these contrasting signals, other professionals of high standing who could bring value to public sector bank boards then hesitate to join such boards, in the belief that good

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[40] Strong support for this perception arises from the manner in which some directors are able to continuously rotate across boards of public sector banks as shareholder directors. Several directors have rotated across banks for over a decade. Rotation is completely absent in private sector banks.

[41] Suspicions that a large proportion of directors get appointed on the basis of political allegiance also leads to intense scepticism that these banks will ever be run in the taxpayers' interest, with the goal of generating good financial returns. In Adam Smith, 'An Inquiry into the Nature and Causes of the Wealth of Nations', 1776 (Vol IV&V, Penguin Publishers, 1999), regarded as the first seminal work in economics, shareholder behaviour in the East India Company in the second half of the eighteenth century is characterised as follows: "Frequently, a man of great fortune, sometimes even a man of small fortune, is willing to purchase a thousand pounds share in India stock merely for the influence which he expects to acquire by a vote in the court of proprietors. It gives him a share, though not in the plunder, yet in the appointment of the plunderers of India...Provided he can enjoy the influence for a few years, and thereby provide for a certain number of his friends, he cares little about the dividend, or even the value of the stock upon which his vote is founded."

[42] Signaling, as a mechanism for individuals to reveal their characteristics, first entered economics in the analysis of the labour market where job aspirants 'signal' their suitability for specific jobs. The pioneering work, subsequently very influential in the understanding of a range of market behaviour, was that of A.M. Spence, 'Job Market Signaling', *Quarterly Journal of Economics* 87, 1973.

governance is not the prime objective of such boards. This further reinforces the very different characteristics between boards in these two segments of Indian banking.[43]

5.7 Selections to Public Sector Bank Boards

The three-phase evolution of board empowerment proposed in Chapter 4 suggests an institutional solution to selecting board members. In Phase 2 the Bank Investment Company (BIC) has already been designated as the institution which will work with bank Chairmen to select new board members, while in Phase 3 the bank boards themselves, suitably empowered in Phase 2, will assume this responsibility.

It is now proposed that in Phase 1 the responsibility of selecting non-official directors should devolve on to the Bank Boards Bureau (BBB). In this phase BBB will, in consultation with bank Chairmen, strive to bring professionals of good standing on to boards and depoliticise the selections. In addition, BBB will also endeavour to bring in directors with banking skills.[44] BBB will need to adopt suitable internal mechanisms to act successfully as a search committee, but the task is readily achievable. It leads to the following Recommendation.

Recommendation 5.6: *During Phase 1 of the three-stage empowerment of bank boards proposed in Chapter 4, the selection of non-official directors should be entrusted to the Bank Boards Bureau.*

During this phase it is also desirable to put an end to the practice of some directors rotating across boards of banks. It is proposed that, from the second phase, a seven-year term be made applicable to directors in public sector banks. After any such term with a bank board, it is also proposed that there be a five-year cooling-off period for a director to return to the same bank board, and a two-year cooling-off period to be appointed to any other bank board. It motivates the following Recommendation:

Recommendation 5.7: *It is proposed that, from the second phase, the maximum term for any director other than whole-time directors be restricted to seven years. Further, after any tenure on a bank board, there would be a cooling-off period of five years, for the director to return to the same bank board, and a two-year cooling-off period for the director to be appointed on the board of any other bank.*

The principle that serving simultaneously on multiple boards can over-commit a director is now better accepted. Overcommitted directors serve less frequently on important board committees such as the audit or the compensation committees, and their presence on bank boards could

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[43] In the signalling literature, the outcome is a 'separating equilibrium' rather than a 'pooling equilibrium'.

[44] It is a matter of concern that, other than whole-time directors, very few professionals with direct banking experience appear to sit on the boards of these banks. This has in more recent years been cited as one of the reasons for the 2008 global financial crisis, as several of the banks in the US and Europe which collapsed or were financially damaged, appeared to have very slender banking skills among their independent directors.

reduce management oversight.[45] It is proposed that public sector banks follow the SEBI prescription which permits directors to sit on the boards of at most seven listed companies, and motivates the following Recommendation:

Recommendation 5.8: *Any director on the board of a public sector bank will be eligible to be a director on the boards of at most six other listed companies.*

Chartered Accountant (CA) directors face special conflicts of interest as they could be partners in firms which might audit the same or other banks. This conflict of interest has been recognised much earlier by the Government, which presently does not permit any partner of a CA firm to be on the board of a public sector bank if the firm is an auditor in any public sector bank. This is achieved by a provision in a 'scheme' issued by the Government under the Bank Nationalisation Act, 1970, which debars a director from holding an office of profit in any public sector bank during his tenure as a director of a nationalised bank.

The Government has recently written to RBI indicating it proposes to amend the provision by restricting this ban to the same bank. It has argued that if any CA of standing is to be appointed on any board of a nationalised bank as a non-official director, the CA and the CA's firm would have to completely withdraw from undertaking any work in any bank. Thereby "only those chartered accountants would remain available for appointments as directors who have not obtained any assignments under any bank, thus raising a very real possibility of persons with hardly any market acceptability and/or competence finding their way by default on the Boards."

Company law provides that directors can sit on boards of companies even if they otherwise profit from a separate association with those companies. It is not uncommon, for instance, to find a paid consultant to a company also appointed a director on the company's board, though company law requires that the director be categorised as non-independent.

The criterion to be adopted in deciding whether a CA should be treated likewise ought not to be 'office of profit' and should instead be 'conflict of interest'. An auditing firm obtains a great deal of client information about a bank which it audits. Every partner or officer of that auditing firm would therefore be conflicted in being on the board of another bank, as this client information should not be used to the detriment of the bank being audited. The director clearly also cannot be on the board of the company audited, as auditor independence would then be questionable. For these reasons it is desirable that the Government does not alter the present restrictions on CAs, and leads to the following Recommendation:

Recommendation 5.9: *A partner or employee of a firm auditing a bank would be conflicted in becoming a director in another bank, in view of the client information which auditors have access*

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[45] Board interlocks (caused when a director of one organisation sits on the board of another organisation) are another aspect of having 'busy directors'. B.N. Balasubramanian, S.K. Barua, S. Bhagavatula and R. George, 'Coping with Corporate Cholestrol: Board Interlocks and Their Impact on Corporate Governance - The Indian Experience", IIM Bangalore, 2012 demonstrate that in 2008 about 6 per cent of directors in Indian listed companies were on boards accounting for 60 per cent of the market capitalisation of companies. The extent of interlock involving banks appears not to have been researched as yet.

to. Likewise, for such partner or employee to be a director in the same bank being audited would violate auditor independence. Therefore, no such partner or employee should be a director on the board of any bank.

Reserve Bank of India (RBI) nominates a director to each bank, and where banks are troubled or raise special concerns, it could nominate more than one director. The principle that RBI as the Regulator and Supervisor of banks should not be on bank boards (and therefore not be party to bank management decisions) is unexceptional. RBI has written to the Government seeking permission to withdraw its nominees (who could either be serving or retired RBI officers, as the Government 'scheme' requires them to have knowledge of 'bank regulation or supervision') from bank boards, except when there are special concerns.

Unfortunately, several public sector bank boards do not appear to function cohesively, and bank Chairmen have the difficult obligation of steering the board deliberations under such conditions. There is a widespread view that RBI nominee directors carry weight with non-official directors and that their views act as a stabilising advocacy. As full board empowerment will occur in Phase 3 of the transition outlined in Chapter 4, it is proposed that the withdrawal of RBI nominee directors be deferred to that phase. While such a deferral to Phase 3 compromises the principle that regulators should not be on bank boards till then, it seeks to pragmatically recognise their present beneficial impact in the context of imperfectly constituted boards. The following Recommendation follows:

Recommendation 5.10: *RBI directors should step down from bank boards during Phase 3 of the transition process, unless a bank is troubled or raises special concerns.*

There is finally the issue of the separation of the Chairman and CEO positions. Here again, during Phase 3 of the transition process when bank boards are fully empowered, it would be desirable for the two positions to be separated. Until then there is a very real possibility of the several Chairmen positions across banks being filled on the basis of political allegiance rather than professional skills. This could imperil banks, would therefore be undesirable, and leads to the following Recommendation:

Recommendation 5.11*: The positions of bank Chairman and CEO should be separated during Phase 3 of the transition process.*

Chapter 6

Ownership Issues in Private Sector Banks

6.1 Existing Ownership Regulation

Governance issues in private sector banks originate from a different set of considerations to those applicable to public sector banks. Several of the fetters which constrain public sector banks, discussed in earlier chapters, are absent. The structure of the board governance problem therefore gets articulated differently: There are issues that arise from ownership constraints stipulated by RBI, and others which arise from the boards themselves. In this Chapter we deal with the former.

Until 2004 there were no ownership restrictions imposed on private sector banks. The changes imposed in that year, further buttressed in 2005, introduced a 5 per cent equity cap on a single financial investor, which could be enhanced to 10 percent with RBI approval. Promoters or controlling shareholders were also expected to reduce their holdings to not more than 10 per cent. Diversification of ownership appeared to follow a US-UK tradition, which also meant that business houses could not take dominant stakes in, and thereby exercise significant control of, banks. This was in contrast to the tradition of business conglomerates controlling banks through *keiretsus* in Japan and *chaebols* in South Korea. The Japanese-Korean model seemed very discredited after the Asian financial crisis of 1997-98.

However the financial crisis of 2008 which affected banks in the US, the UK and several parts of Europe suggests that the Anglo-Saxon model did not necessarily lead to better governance in banks. Risk mitigation, an aspect of governance in bank boards, certainly appeared to have collapsed, threatening several well-known banks with bankruptcy.[46] It is therefore legitimate to ask whether placing stringent limits on bank ownership in India serves a desirable governance imperative.[47]

In 2013 RBI issued a fresh set of regulations which would govern the licensing of banks in future. There are some significant differences with the 2004 regulations. New banks would henceforth need to be owned by non-operative financial holding companies (NOFHCs) with promoters forbidden from holding direct stakes in these banks; a higher minimum capital adequacy of at least 13 per cent has been demanded; all bank-type lending businesses conducted within a promoter group through any financial services company (including a non-banking finance company) would need to be merged with the bank licensed; initial NOFHC equity would need to be at least 40 per

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[46] One US bank affected deeply by the crisis eventually got recapitalised by a Japanese financial conglomerate, which now holds a 22 per cent stake, driving home the irony further.

[47] The 2004 guidelines could have had other objectives as well, including preventing foreign banks from acquiring significant stakes in Indian banks. However such limited objectives could have been achieved through more nuanced regulatory changes.

cent for 5 years, and no more than 20 per cent within 10 years and 15 per cent within 12 years; and foreign investment would be restricted to 49 per cent in the first five years.

While it is legitimate to ask how two sets of guidelines applicable to private sector banks can constitute a level regulatory playing field, it must be presumed that RBI will tighten regulation for existing private sector banks to converge to the 2013 guidelines. Not all of this will be immediately feasible (for instance the setting up of NOFHCs for existing banks) but RBI would do well do minimise the dissonance rapidly. In some ways this regulatory duality reinforces the patchwork nature of bank regulation, segmented by differing licensing regimes based on ownership and history. The one-license regime advocated in Recommendation 4.8 therefore benefits banks in both the public and private sector.

6.2 Ownership Regulations in Other Jurisdictions

We examine four jurisdictions, of which three are in Asia.

In Indonesia, a 25 per cent stake is defined as a controlling stake, requiring central bank approval. Non-controlling stakes, lower than 25 per cent, face no other constraints and are permitted without approval. This freedom is permitted for overseas investors as well.

In Japan, the threshold is defined as applicable to a major shareholder, and is pegged at 20 per cent, or 15 per cent if the shareholder has material influence. Major shareholders need central bank approval, while others do not, including those from overseas. Thus the threshold is 15 per cent if control is sought to be exercised, and 20 per cent in other situations as for instance in a purely financial investment.

In South Korea, the norms are more nuanced, and differentiate between a non-financial business (termed NBFOs) and a financial business. NBFOs can own upto 4 per cent freely, but can go upto 9 per cent with central bank approval. Financial businesses can go upto 10 per cent freely, but can also go higher with successive approvals to get beyond 10, 25 and 33 per cent.

In Germany, there appear to be no specific regulations limiting controlling or major shareholding in banks.

6.3 Authorised Bank Investors

If India's private sector banks are to grow, it appears desirable that they be permitted to access pools of capital available in India and elsewhere without imposing excessively narrow investment limits. In addition, as Box 6.1 argues, there is empirical evidence to suggest that block investors could enhance governance. When individual holdings are small and shareholders are diffused, they also tend to be disengaged. Allowing larger individual blocks of shareholding helps to correct this, and is generally good for governance. It is therefore proposed that RBI permit greater

investment flexibility to a category termed Authorised Bank Investors (ABIs), defined to include all funds with diversified investors which are discretionally managed by fund managers and are deemed fit and proper.

Box 6.1: Large Shareholders and Corporate Policies

There is an expanding literature within financial economics of the positive impact of block shareholders on corporate governance. The following are regularly cited:

J. Sarkar and S. Sarkar, ' Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India'. International Review of Finance, 2000, examine the impact of block shareholders in Indian companies. They point to a non-linearity in the impact of foreign institutional investors: as their shareholding proportion rises in companies, so does the value of the firm, but that this effect becomes more pronounced once the extent of holding crosses 25 per cent. In contrast they find that government controlled institutional investors have no positive impact on company value. A more recent study by J. Sarkar, 'Ownership and Corporate Governance in Indian Firms', *Journal of Corporate Governance: An Emerging Scenario*, 2010, argues that the pervasiveness of insider control in Indian corporates has persisted, and that outside blockholders seldom have controlling stakes or the ability to act as a countervailing force against insiders, although 'the picture is somewhat better for larger firms'.

H. Cronqvist and R. Fahlenbrach in 'Large Shareholders and Corporate Policies, *Review of Financial Studies*, 2009, examine the effects on corporate policies of the presence of different categories of block shareholders. They find statistically significant and economically important block holder effects in investment, financial, and executive compensation policies. For activists and pension funds, they find significant positive effects in respect of corporate policies. For mutual funds, investment and financial policies are impacted; for leveraged buyout firms, capital expenditures, leverage ratios and cash holdings are affected; and for venture capital firms there are significant effects related to investment, R&D policy, and cash holdings. Interestingly, no significant positive impact was found through the presence as investors of insurance firms, money managers, trusts, banks or university endowments. Most importantly, they find that shareholders with a larger block size, board membership or direct management involvement are associated with larger effects on corporate policies and firm performance.

R. Chung, M. Kim and J. Kim in 'Institutional investors and opportunistic earnings management', *Journal of Corporate Finance*, 2002, examine whether large institutional shareholdings in a firm deter earnings management in reported profits. Using discretionary accounting accruals as the measure of earnings management, the study finds that the presence of large institutional shareholdings inhibits the altering of reported profits towards the managers' desired level, and thereby contributes to improved governance.

ABIs would therefore include pension funds, provident funds, long-only mutual funds, long-short hedge funds, exchange-traded funds and private equity funds. These funds would qualify only where they are diversified and are discretionally managed by a fund manager. Also, by way of explanation, merely because a hedge fund might go short on a bank stock constitutes an insufficient ground for excluding it.

ABIs would exclude all proprietary funds (including those which are hedge funds). Corporates setting up proprietary funds will therefore also not qualify, as the funds will not be diversified. If funds have been subject to stringent legal action in other jurisdictions, or have been badly managed, they too can be disqualified as not fit and proper. Non-banking finance companies and insurance companies will also not qualify as they are not registered as funds, and large stakes held by them are liable to acquire a strategic gloss. These excluded categories would be subject to different limits.

It is then proposed that ABIs be permitted a 20 per cent investment stake without regulatory approval if the investment is purely financial. ABIs which are given board representation, and thereby a measure of influence, should however be permitted a lower 15 per cent investment limit without regulatory approval. All other investors should be permitted no more than 10 per cent. These enhanced limits would attract greater capital into banks and, through the presence of block shareholders, provide promise for exacting more demanding governance requirements from bank managements.

The present guidelines have a uniform limit of 5 per cent for all non-promoter financial investors, which at RBI's discretion can be raised to 10 per cent. RBI has in the past been inconsistent in approving proposals for this enhanced investment limit. On the assumption that there should be good reasons for denying permission, rather than good reasons for providing it, it would be desirable to raise the investment limit for investors other than ABIs to 10 per cent.

It is also proposed that henceforth RBI distinguishes investors on the basis of whether or not they exercise influence, in addition to the criterion of whether or not they are promoters. The promoter concept could have less relevance many years after companies have been set up, as other shareholders could come in and exercise varying degrees of influence. Any shareholder with a nominee on the bank's board would be deemed a material shareholder.

6.4 Fit and Proper

RBI has been assiduous, in its periodic circulars, in recommending that boards follow the notion of 'fit and proper' in its identification of investors and of board directors. Despite certain principles

laid out by RBI, their applicability to specific contexts could lack precision.[48] There are two issues meriting discussion.

At a minimalist level, fit and proper is an exclusion criterion. Potential directors convicted of fraud or incoming investors who have been subject to major criminal penalties can be argued to be not fit and proper. This minimalist interpretation signifies who should be excluded rather than included.

But bank boards need to aim higher as an inclusion category, seeking talented professionals on boards and reputed investment funds as shareholders, for the governance and reputation gains which these would bring the bank. Reputed investment funds ask demanding questions of bank managements, and are known to exit when answers are unsatisfactory. Talented directors similarly improve board governance. Fit and proper cannot be the criterion for such inclusion, and needs to move to a more demanding threshold.

Nevertheless, as an exclusion criterion the concept has utility, though RBI would need to be vigilant that it is not misused. It may also be impractical to expect a detailed due-diligence to be conducted by RBI or banks prior to investment. If however RBI concludes at any stage, based on information brought before it, that an investor in a bank is not fit and proper, RBI would have the right to freeze the investor's voting rights and seek disinvestment from the bank within a specified period after giving the shareholder the opportunity of being heard. As the initial onus of being regarded as fit and proper therefore falls on the investor, RBI should consider providing an informal guidance service to investors on whether any past regulatory or other action against an investor could affect its fit and proper categorisation.

Based on this discussion, the following three Recommendations are proposed:

Recommendation 6.1: *RBI should designate a specific category of investors in banks as Authorised Bank Investors (ABIs), defined to include all funds with diversified investors which are discretionally managed by fund managers and are deemed to be fit and proper. ABIs would therefore include pension funds, provident funds, long-only mutual funds, long-short hedge funds, exchange-traded funds and private equity funds (including sovereign wealth funds) provided they are diversified, discretionally managed and found to be 'fit and proper'. ABIs would exclude all proprietary funds (including those which are hedge funds or set up by corporates), non-banking finance companies and insurance companies.*

Recommendation 6.2: *A single ABI should be permitted a maximum 20 per cent investment stake in a bank without regulatory approval provided it possesses no right to appoint a board director. An ABI which is given board representation, and thereby exercises a measure of influence, should be permitted a lower 15 per cent maximum investment limit without regulatory approval. Every other investor should be permitted no more than 10 per cent without regulatory approval.*

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[48] This is one of the ambiguities of principles-based regulation and, where contested, is eventually resolved by the courts. Thus recently, a bank board has denied a director's seat to a well-qualified professional representing a promoter shareholder on other grounds, arguing that the professional is not 'fit and proper'.

Recommendation 6.3: *It would be impractical for either RBI or a bank to conduct a prior scrutiny on whether an investor is 'fit and proper' before an investment occurs. If, however, at any stage and based on information laid before it, RBI concludes that an investor in a bank is not fit and proper, RBI would be entitled to freeze the investor's voting rights in the bank and to seek its disinvestment within a specified time period. As the initial onus of belief in being fit and proper therefore falls on the investor, RBI should also consider offering an informal guidance service on whether past regulatory or other action against an investor would disqualify categorisation as fit and proper.*

6.5 Material Investors

Material investors in banks include both promoters who set up banks and others who exercise some measure of influence in the board by nominating a director. The earlier discussion proposed a framework for limiting investment by ABIs who also exercise influence. But there could be other categories of investors as well who exercise influence. The 2013 regulations require that promoters of banks would need an initial minimal holding of 40 per cent, and that within 10 years this would need to be lowered to 20 per cent and within 12 years to 15 per cent.

The rationale for the insistence on lowering the investment limit on a continuing basis is presumably that banks should become broad-based after some years, though it must be observed that there appears to be no such requirement in the other jurisdictions within Asia discussed earlier. It must also be observed that if the maximum shareholding for promoter investors is set very low, the alignment of incentives between shareholders and managements could weaken, and banks could be more vulnerable, as managements could then be primarily concerned with their own interests rather than those of shareholders. This is a fundamental corporate governance problem across all companies, but RBI could be in danger of exacerbating it in relation to banks by asking for a significant dilution to as low as 15 per cent.[49] A higher limit of 25 per cent appears desirable, particularly in view of the separate recommendation now made that ABI investment could go up to 20 per cent. This motivates the following Recommendation:

Recommendation 6.4: *For promoter investors other than ABIs it is proposed that the continual stake ceiling be raised to 25 per cent.*

Table 6.1 summarises the ceiling on bank stakes held by different categories of bank investors. Any investor who gets a board seat would be categorised as a material investor.

[49] Setting low limits for continual investment holdings without effective enforcement further lowers the credibility of regulation. As at end-December 2013 the promoters of all but one of the new private sector banks were in breach of the ceiling, though the regulatory justification provided is that of the promoters 'being of good standing'. Higher limits with effective enforcement are preferable to lower limits which apparently cannot be enforced.

Category of Investor	Maximum stake (%)
Promoter (Continuing stake)	25
ABI without influence	20
ABI with influence	15
Other Investors	10

Table 6.1: Ceiling on bank stakes held by different categories of investors

6.6 Listing of Banks

There are presently four unlisted private sector banks.[50] It is argued that listing introduces a new layer of shareholder accountability and therefore of governance, and it has been RBI policy to encourage early listing. The 2013 guidelines for new private sector banks, for instance, mandate that banks should list within three years of commencing business.

From a capital markets perspective, the time of listing must depend on several factors: whether the bank has the management skills and the competitive positioning to create value for incoming shareholders (difficult to gauge in three years); whether there will be adequate market interest in the stock (often dependent on overall market trends, difficult to compress with certainty into the final months of a three year window); and the recent financials of the bank and their likely future trajectory (particularly if the financials are poor in the initial years). Further, 'good governance' promoters of companies (including banks) may wish to grow their businesses slowly and cautiously, their ability to generate value in their investments within such a short period is compromised, and such promoters are-short-changed by early listing; equally, the ability of 'poor governance' promoters to justify selling quickly is enhanced, and minority shareholders are subsequently shortchanged.

It is therefore puzzling as to why RBI has argued in favour of early listing from a governance standpoint, as premature listing could be damaging to incoming minority shareholders' interests. Asymmetric information between a company management and incoming investors at the stage of the initial public offering is acute: if existing governance at the time of listing is indifferent, but not perceived as such by the market, minority shareholders generally fare poorly.

It therefore appears desirable that the time of listing should be entirely at the discretion of the bank management, and not be subject to any regulatory pressure, whether in the case of the existing unlisted banks or the banks licensed under the 2013 guidelines. It leads to the following Recommendation:

Recommendation 6.5: *It would be inappropriate for regulation to stipulate a period within which banks should be listed, particularly from a governance perspective, as premature listing could be*

[50] Catholic Syrian Bank, Ratnakar Bank, Tamilnad Mercantile Bank and Bank of Nainital. Present RBI instructions require the first two banks to list by December 2014. Bank of Nainital has a shareholding exceeding 99 per cent held by the listed Bank of Baroda.

injurious to minority shareholder interests. It would therefore be desirable to modify the 2013 guidelines for new private sector banks accordingly.

6.7 Capital for Distressed Banks

If a bank becomes distressed because of an escalation in bad debts, its need for capital rises sharply merely to meet regulatory norms on adequate capital. Existing policy appears to show no special dispensation for such banks, and it is presumed that a stronger bank would take it over. However, elsewhere in Asia, and particularly after the Asian crisis of 1997-98, regulation has permitted long-term funds to take controlling stakes in such distressed banks. These are typically private equity funds, including sovereign wealth funds. Indonesia and South Korea are examples of countries which have encouraged this, thereby bringing in much needed capital and, through a new management, turning round the banks. Box 6.2 provides details of select transactions of this nature within Asia.

Box 6.2: Private Equity Investments into Distressed Asian Banks

Since the Asian financial crisis, several private equity funds, including sovereign wealth funds, have been permitted to take controlling stakes in distressed banks. In Indonesia Temasek took a 51 per cent stake in Bank Danamon and a 68 per cent stake in Bank International Indonesia, while Farallon acquired a 51 per cent stake in Bank Muamalat Indonesia; in South Korea Newbridge Capital obtained a 48 per cent stake in First Korea Bank, and Carlyle a 16 per cent stake in KorAm Bank. In Japan, ORIX and Softbank Investment Corporation took control of Nippon Credit Bank, while WL Ross had a control investment in Kofuku Bank.

Clearly, private equity has been a valuable source of capital for distressed banks.

Purely for distressed banks, such a strategy for India would be very helpful. RBI would need to maintain a list of such private sector banks on a continual basis and to discreetly advise the banks of its willingness to permit larger control blocks to be brought in.

If the strategy is to be successfully executed, the control blocks would need to be significant. It is proposed that private equity funds, including sovereign wealth funds but excluding all other ABIs, be permitted to take up to a 40 per cent controlling stake. The justification for permitting private equity funds to invest in distressed banks through such transactions lies in their long average investment duration and their proven record of having done so in other jurisdictions. It leads to the following Recommendation:

Recommendation 6.6: *For banks identified by RBI as distressed, it is proposed that private equity funds, including sovereign wealth funds, be permitted to take a controlling stake of upto 40 per cent.*

Permitting larger block holdings than at present in the manner proposed above will not lead to incoming investment transactions unless shareholders have voting rights in proportion to their shareholding. The maximum voting rights were earlier pegged at 10 per cent, but an amendment in 2012 has enabled raising this to 26 per cent. RBI has hitherto not issued regulations in accordance with the legislative change. It is unclear how not permitting voting rights in proportion to shareholding can constitute good regulatory practice, and this leads to the following Recommendation:

Recommendation 6.7: *The principle of proportionate voting rights should constitute part of the regulatory bedrock which fosters good bank governance, as it aligns investors' powers in shareholder meetings with the size of their shareholding. It is therefore desirable for RBI to raise the limit for voting rights to 26 per cent, in accordance with legislative changes recently enacted. It is also desirable to further amend legislation to remove all constraints on voting rights in order to align it with company law.*

6.8 Entrepreneur-Led Banks

India's experience with entrepreneur-led banks has been mixed, but there are countries where such banks commonly exist. The US and Hong Kong (the latter with its family-owned banks) are jurisdictions where such banks are plainly visible. Several existing Indian public sector banks started as entrepreneur-led banks, and evidence of this is to be also found in the old private sector banks. In particular, where entrepreneurs have displayed the ability to run other financial services businesses successfully by handling risk management well, there is greater confidence in their ability to run banks as well. This could be one channel for the licensing of new banks.

In entrepreneur-led banks there could however be a major governance issue. The entrepreneur is the controlling shareholder in the bank, but could also come in as the bank's CEO. In other banks there is a separation between ownership and management, but this would be absent in entrepreneur-led banks. Board independence, which requires the board to act in the interests of all shareholders, and not just the controlling shareholders, could be compromised. It is therefore often suggested that in such banks, the entrepreneur-investor ought not to be permitted to become the bank's CEO. It must be recognised, however, that this argument would negate the very rationale of professionally qualified and experienced entrepreneurs starting banks, for the drive to run a bank would often underpin an investor's interest in injecting capital into the bank.

An alternative mechanism would be for RBI to retain confidence that such boards are adequately independent. If in an entrepreneur-led bank the board commands little credibility that it is is adequately independent with professionals of high standing, then there is a serious issue of board independence and therefore of governance; in such cases, permitting the controlling shareholder

to remain as the CEO risks misgovernance. Where however the bank board is well diversified and commands credibility for its independence, there need be no misgivings on the controlling shareholder remaining the CEO.

Section 7.5 in Chapter 7 discusses the manner in which the structure of non-independent boards in the old private sector banks can lead to conflicts of interest, and so the governance issues when a controlling investor also comes in as the CEO, are real, not imaginary. The discussion motivates the following Recommendation:

Recommendation 6.8: *Where the principal shareholder in an entrepreneur-led bank is also the bank's CEO, RBI should satisfy itself that the board is adequately diversified and independent, with professionals of high standing. Where RBI lacks confidence of such independence, the controlling shareholder should be asked to step down as CEO.*

Chapter 7

Boards of Private Sector Banks

7.1 Board Governance

Private sector banks face none of the external constraints that fetter the boards of public sector banks. Their boards operate under company law, new directors are chosen by existing boards, they are keenly involved in the appointments of their CEOs, and consequently board ecology tends to be more conducive to participation in the big-picture strategic themes that concern the banks.

What is a little less clear is how strongly these boards participate in an understanding and shaping of risk management within the banks. Several issues and techniques of risk management appear arcane, demanding special analytical skills which several board members would lack. Where some of the independent members possess these skills, boards are able to exercise oversight over risk management practices; but where these skills are lacking among independent directors, oversight by the board becomes weaker.

Along with risk management, oversight is also needed on the quality of the loan asset portfolio, as under-reporting NPAs and other stressed assets sensitively influences the integrity of financial reporting. Clearly all banks need to be sensitive to this, but because in private sector banks senior management is incentivised on the basis of bank profitability, and the compensation paid out to senior management - through stock options - is in substantial measure contingent on the stock price of the bank, extra vigilance is needed. There is a potential incentive to evergreen assets in order that provisions do not make a dent in profitability, and the incentive is the strongest in the new private sector banks where a significant proportion of compensation could accrue through encashing these stock options. As evergreening is a practice representing mis-governance, it is critical that oversight on this be exercised. The top managements of several private sector banks do display resolve in ensuring that the practice is strongly discouraged (and for large loan amounts evergreening requires the support of top management), but it is vital that all banks remain resolute. Successive lines of defence are the bank CEO, bank audit committee, bank board, bank auditors and the RBI supervisors.

India has seen high nominal interest rates for over four years, with a slowing down of growth, particularly in infrastructure projects and in manufacturing industry. There are several asset-heavy businesses which have borrowed liberally from banks and whose cash flows are unable to support repayments to banks. Consequently both the gross NPAs and restructured assets within banking have burgeoned.

What is puzzling is that as a proportion of loan assets the deterioration in asset quality is almost entirely in public sector banks, with a remarkable stability in the asset quality of private sector banks. Table 7.1 provides data to confirm that as at end-December 2013 stressed assets in public

sector banks had reached alarming proportions, but not in private sector banks. On the contrary, gross NPAs as a percentage of loan assets in private sector banks were lower in December 2013 than they were in March 2011. There appear to be three broad explanations for such a divergence. Either private sector bankers are 'better' bankers in the companies they choose to lend to;[51] or they are able to sell their assets to other banks and NBFCs before the assets become problematic; or else they successfully evergreen their assets.

	Mar-11	Mar-12	Mar-13	Dec-13
As a % of Gross Advances	Public Sector Banks			
Gross NPAs	1.84	2.45	3.19	5.07
Restructured Assets	3.74	6.23	8.30	7.09
Total Stressed Assets	5.58	8.68	11.49	12.16
	Private Sector Banks			
Gross NPAs	2.29	1.95	1.84	2.06
Restructured Assets	0.61	1.54	1.50	2.07
Total Stressed Assets	2.90	3.49	3.34	4.13

Table 7.1: Reported Trajectory of Stressed Assets

As methods of evergreening can also be sophisticated, it is sometimes difficult for external observers to detect such practices. With RBI having moved away from detailed to risk-based supervision, the Annual Financial Inspections also investigate the reporting accuracy of NPAs by banks less rigorously. It appears desirable therefore that RBI conducts random and detailed checks on asset quality in these banks. The primary defence against evergreening must however come from the CEO, the audit committee and the board. The audit committee, in particular, needs to be particularly vigilant. RBI's recent directive requiring a classification of special mention assets could be particularly helpful to the audit committees and boards, as they will permit a scrutiny of the manner in which each special mention asset either remained standard or else unravelled as a stressed asset.

If despite this, significant evergreening is detected by RBI supervisors, it must mean that evergreening is wilful, with support from sections of the senior management of the bank. It then becomes necessary to levy penalties. Penalties on banks adversely affect shareholders, and it is necessary that the prime beneficiaries of evergreening be instead targeted and the proceeds be restored to the bank. The measures would include the cancellation, in part or full, of unvested stock options, and the claw-back by the bank, in part or full, of monetary bonuses. RBI has in 2012

[51] The question of whether private sector bankers are 'better' bankers and therefore have superior loan portfolios merits a more rigorous analysis. The Altman Z-score has been a popular method to demarcate between strong, weak and stressed companies. Using the CMIE Prowess database on firms that banks lend to, and collating that information to the bank-level to obtain the corporate portfolios of public and private sector banks, Box 7.1 indicates on the basis of Z-scores that 18.4 per cent of borrowers in public sector banks are Altman-stressed, while 18.6 per cent of borrowers in private sector banks are Altman-stressed. Box 7.1 also contains a histogram which depicts the representation of borrower quality in the three ranges for public and private sector banks. It must be emphasised that the scores pertain to bank borrowers and not to bank assets.

issued guidelines which permit such cancellation and claw-back, and the regulatory framework for this is therefore already in place. The existence of any such wilful and significant evergreening suggests that the board and the audit committee had also not been adequately vigilant, and it therefore appears desirable that the Chairman of the audit committee be asked to step down from the board. The discussion motivates the following Recommendations:

Recommendation 7.1: *Wherever significant evergreening in a bank is detected by RBI, it is recommended that RBI imposes penalties wherein:*

1. Unvested stock options granted to officers who have indulged in the practice, and to all whole-time directors, be cancelled in part or in full.

2. Monetary bonuses paid to such officers and to all whole-time directors, be clawed back by the bank, in part or in full.

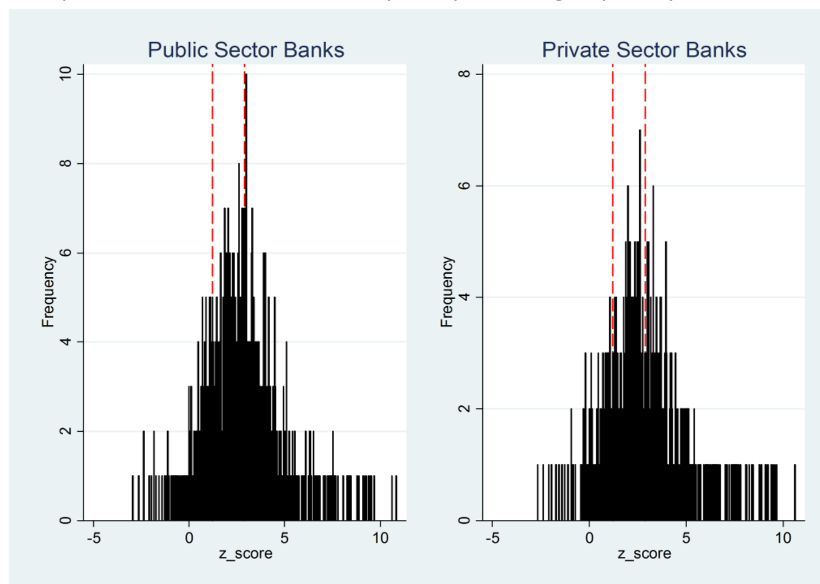
3. The Chairman of the audit committee be asked to step down from the board.

Recommendation 7.2: *As the stance of RBI supervision has now moved from detailed to risk-based supervision, it is desirable for supervisors to conduct random detailed checks on the reported quality of banks' asset portfolio, particularly in those banks where compensation through stock options is liberally provided.*

Box 7.1: Evidence of borrower quality as of December 2013

		Percentage of assets in the particular category	
Qualityof borrowers	Range for Z-score	Public Sector Banks	Private Sector Banks
Stressed	Z-score<1.22	18.4%	18.6%
Low Quality	1.22<=Z-score<2.9	39.2%	39.6%
High Quality	Z-score>=2.9	42.4%	41.8%

Proportion of stressed, low quality and high quality borrowers



Distribution of borrower quality for public sector and private sector banks

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7.2 Mis-selling

The new private sector banks have achieved dominance in the distribution of third party products, particularly insurance and mutual fund products.[52] Life insurance distribution, in particular, has constituted a major source of fees earned, but has also given rise to widespread criticism of mis-selling.[53]

India lacks a customer protection law for financial products which can lead to speedy redressal of customer complaints, but there is much that boards of banks can do to protect customer interests.[54] The present practice is for customer complaints to get monitored by a Customer Grievances Committee, but these grievances generally relate to complaints of poor service or errors made by banks. It therefore appears desirable for the boards to also define for third-party products what constitutes proper selling practices. Products need to be matched with customer demographics, customer income and wealth, and customer risk-appetite. Seen differently and through an example, to position aggressive equity-linked products to low or middle income customers nearing retirement cannot be labeled a good selling practice, and would constitute mis-selling. Although banks have begun this exercise of defining customer protection, board oversight appears desirable if, in the pursuit of aggressive business goals, banks are not to lapse into diluting the focus on customer protection. The Recommendation below follows:

Recommendation 7.3: *Boards of all banks, and particularly of the new private sector banks because of their dominant market share, need to provide oversight on customer protection in the distribution of third-party products, including matching the positioning of these products with customer demographics, customer income and wealth, and customer risk-appetite; and ensuring that product features are clearly explained to the customer.*

7.3 Board Compensation

The Companies Act permits up to 1 per cent of a firm's profit to be paid out as commissions to board members. However, other than for the non-executive Chairmen, RBI does not permit part-

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[52] In the year ended March 2012, private sector banks had an estimated 53 per cent share of the bancassurance business and had an estimated 47 per cent share of the mutual fund sales by banks.

[53] This criticism applies to public and private sector banks, as the Cobrapost sting operations in 2012 brought into public focus, and consequent to which penalties were levied on banks by RBI. However, given the prominence of the new private sector banks in these businesses, these banks would need to lead the efforts at safeguarding the interests of customers.

[54] The Financial Sector Legislative Reforms Commission (FSLRC), which reported in 2013, provided the first comprehensive design of a law on consumer protection for the financial sector, including recommending the establishment of a Financial Redressal Agency to redress complaints of retail consumers through a process of mediation and adjudication.

time directors of banks to be paid any remuneration other than sitting fees. Private sector banks argue that they face difficulties in persuading highly talented people from accepting membership of their boards, because board remuneration in well-run non-banks is superior.

Public sector banks presently also do not permit remuneration to directors other than sitting fees, and these are at more modest levels than those paid in private sector banks. There are two sources of inequality that need to be weighed:

1. Inequality in board compensation between public sector and private sector banks getting further aggravated if a share of profits is paid to private sector bank board members in accordance with the Companies Act.

2. Inequality in board compensation between private sector bank boards and boards of non-banks, because RBI prevents the Companies Act provisions from being made applicable to private sector banks.

On any reasonable presumption, the first inequality is the more critical, and will further destabilise the public sector banks, and therefore the composite banking system. Equally, private sector banks cannot be held hostage permanently to the refusal of the Government to align compensation for its bank boards in line with company law. Fortunately, the three-phase transition process for public sector banks outlined in Chapter 4 will lead to the constitution of fully empowered boards in Phase 3. Section 4.8 proposed conditions under which compensation constraints on public sector banks could also be eased. If the Government finds these conditions unacceptable, then the playing field between the public sector and private sector banks cannot be further levelled. With such a conscious decision of the Government, it appears fair to allow private sector bank board compensation to be guided by company law provisions and for the existing constraints to be relaxed. The Recommendation below follows:

Recommendation 7.4: *Profit-based commissions for non-executive directors should be permitted in, but not before, Phase 3 of the transition mechanism proposed in Chapter 4.*

7.4 Age of Directors

The new Companies Act, 2013 prescribes a minimum age of 21 for directors of companies and a maximum age of 70, though the latter can be extended by shareholders through a special resolution.

For private sector bank boards, RBI has imposed a different set of constraints. The minimum age is stipulated as 35. It is unclear why a separate regulatory filter for a minimum age is needed.

For part-time directors, a maximum age of 70 for appointment or re-appointment is stipulated. This is broadly in consonance with the Companies Act.

For whole-time directors, no maximum age has been stipulated, and decisions have been taken on individual applications. The bank CEO's job is an onerous one, and it is proposed that a maximum

age of 65 be prescribed. It would however be wise for boards to recognise and make possible a succession process which brings in younger people as CEOs, which an excessively long tenure of an incumbent might otherwise preclude. This perspective leads to the following Recommendation:

Recommendation 7.5: *The minimum and maximum age prescribed by the Companies Act at the time of appointment should be applicable to all directors of private sector banks. For whole-time directors, the maximum age should be 65.*

7.5 Board Governance in old Private Sector Banks

The old private sector banks - those which escaped the nationalisation of the 1960s and 1970s because of their small size - raise an altogether distinctive set of issues in board governance. Although these banks began as community banks (with ownership and management of each bank tightly controlled by a dominant religious or caste group to which the bank promoter belonged), and many of them continue to conduct a large proportion of their business in the states surrounding their headquarters location, they have evolved into and represent diverse governance styles. Some have attempted to outgrow their historical origins and imitate the new private sector banks, by bringing in diversified boards comprising the professionally successful, and by broad-basing the senior management. Some others have brought in CEOs from outside and have aspirations of becoming all-India banks, but the control of the community on board composition and decisions continues to be discernible, if tacit. Finally, there are other banks which have styles of management where the community hold continues to be explicit, and tightly exercised in all strategic matters concerning these banks.

Where the community influence in the management of these banks continues to be visible - however tacitly exercised - the nature of bank governance, and therefore problems arising out of it, tend to differ from those of other banks. There are three elements to the manner in which these banks are governed. First, the hold of the community generally gets exercised through select shareholders, generally related to or descendants of the original bank promoter.[55] The designation of a 'promoter director' develops, of a director who derives authority from being part of the founding promoter's family. This is not a designation recognised by RBI, but is nevertheless commonly used in such banks. The promoter director also has the support of other shareholders, generally close to the family, and therefore controls voting in shareholder meetings.[56] Second, the promoter director is instrumental in deciding the composition of the board and is thereby able to control board decisions. Third, the promoter director or one of his associates typically sits on committees such as for employee promotions at various levels, which in the new private sector

[55] Unsurprisingly, factions sometimes develop between rival groups. In one bank this has become acrimonious to the point where the matter has been in court for several years, further complicating RBI's search for a regulatory solution to the dispute.

[56] RBI frowns on shareholders 'acting in concert' while being subject to the 5 per cent investment ceiling. This is a fuzzy concept in the context of legally separate shareholders with the right to vote in shareholder meetings in accordance with their preferences and, as the case of old private sector banks demonstrates, almost impossible to police.

banks would be under the purview of the CEO. It is not uncommon to find credit proposals too reaching the promoter director before they come to the CEO, and consequently borrowers too approach such directors in the first instance, disempowering the bank CEO.

As a consequence, a link is forged by certain shareholders which extends from the shareholder body to the board to the executive management. The promoter director exercises control in shareholder meetings, likewise exercises control in the board, and eventually exercises control over employees. The community hold thereby also extends to the employees. By the standards of the new private sector banks the CEO becomes very disempowered. While in public sector banks it is the boards which are disempowered, in the old private sector banks it is the CEOs.

It is unlikely that this could be the preferred regulatory stance for managing old private sector banks, and although some old private sector banks are now more professionally managed there are others where the characterisation above would not be inaccurate. Historically, when depositors and borrowers came largely from neighbouring districts to where the bank was headquartered, such local knowledge could arguably have been beneficial. With these banks now having extended their businesses to multiple states, the structure of managing these banks must necessarily change. None of the following individuals or groups — the controlling shareholder, the family he represents, or the community he is a part of — should be permitted to hold sway across different governance levels and structures of these banks. It appears desirable therefore that RBI looks closely at board composition and, where it is dissatisfied that it lacks adequate independence from the promoter director's control of the bank, mandates that the appointment of the bank's directors would require prior RBI approval. It is also advisable for RBI to reassert the autonomy of the bank CEO in the executive management of the bank and of its employees, as against the direct interventions of the board, by examining the precise areas of intervention by directors in committees and outside of it, and for RBI to mandate a separation between board oversight and executive autonomy. The discussion above leads to the following Recommendations:

<u>Recommendation 7.6</u>: *For old private sector banks where RBI has doubts about whether boards are adequately independent of the controlling shareholders of the banks, RBI should mandate that all director appointments be made with the prior approval of RBI. It should be RBI's endeavour to ensure adequate director independence in the board.*

<u>Recommendation 7.7</u>: *In old private sector banks where RBI has doubts about whether the CEO has full control over the executive management of the bank, it should examine the precise areas of intervention by directors in bank committees and outside of it, and mandate a separation between board oversight and executive autonomy.*

Chapter 8

Legislation

8.1 The Rationale for Legislation

This Report has recommended that public sector banks make a structured migration from the corporate governance framework derived from the enactments under which they are presently constituted to one governed by the Companies Act and the Banking Regulation Act. This would thereby lead to a uniform framework for corporate governance for the entire banking sector, and would impose stronger governance standards on boards of public sector banks.

8.2 The Bank Boards Bureau and its Jurisdiction

In the first phase, there are two major requirements. First a Bank Boards Bureau (BBB) needs to be constituted. It is proposed to do so through a Scheme under the Bank Nationalisation Acts and through Rules under the SBI Act and the SBI (Subsidiary Banks) Act. While BBB could also be set up through a Government Resolution (similar to the manner in which SEBI was initially constituted), the existing Acts under which the public sector banks have been constituted offer a convenient way of empowering BBB. Annexure 1 contains provisions of the draft Scheme or the draft Government Resolution and Annexure 2 the draft rules.

8.3 Migration to the Bank Investment Company

The second requirement during the first phase is to pass necessary legislative amendments. The new legislation would repeal the Bank Nationalisation Acts [formally, the Banking Companies (Acquisition and Transfer of Undertakings) Acts of 1970 and 1980], The State Bank of India Act,1955 and the State Bank of India (Subsidiary Banks) Act, 1959. The banks under these enactments would be incorporated under the Companies Act and be regulated by RBI under the Banking Regulation Act. The legislation proposed would also create the Bank Investment Company (BIC) to which the Government's investments in banks would be transferred along with powers presently exercised in relation to the governance of banks. Annexure 3 contains the draft legislative provisions. The passing of this legislation would initiate the second phase during which BIC would be empowered to exercise governance powers in respect of banks with the intent of professionalising the bank boards and improving the financial returns to the Government. These powers would include the appointment of bank Chairmen and of other directors.

8.4 Transition to Independent and Empowered Bank Boards

The third phase would involve BIC transferring several governance powers to the boards of banks in consultation with RBI. The pace at which this transfer of powers occurs will vary across banks, based on the confidence of BIC and RBI about the empowerment, domain skills and independence in each board. In this third phase the post of Chairman and CEO would be separated, each bank board would be responsible for CEO succession, and would also be empowered to appoint new independent directors. The draft provisions in Annexure 3 enable this framework.

ANNEXURE 1

Draft Scheme under the Bank Nationalisation Acts / Draft Government Resolution

In exercise of powers conferred upon it by Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) and Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), the Central Government, after consultation with the Reserve Bank, hereby makes the following Scheme namely.—

[OR]

No. [▪].— Whereas the Government of India has decided to set up a Bank Boards Bureau to strengthen corporate governance of nationalised banks and to make transparent provisions for selection and appointment of directors of nationalised banks, the Government of India hereby publishes in the Official Gazette a Government Resolution in terms of the following Order.—

CHAPTER I

TITLE AND DEFINITIONS

1. Short title and commencement.— (1) This [Scheme / Government Resolution] may be called the Nationalised Banks (Corporate Governance) [Scheme / Order], 2014.

(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

(3) The notes set out along with the provisions of this [Scheme / Order] are an integral part thereof setting out the legislative intent to guide the interpretation of this [Scheme / Order].

2. Definitions.— (1) In this [Scheme / Order], unless the context otherwise requires,—

(a) "Act" means each of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980);

(b) "bank" means any nationalised bank, SBI, SBI Subsidiary or any other banking company;

(c) "Board" means the board of directors established under the respective Scheme in respect of any nationalised bank;

(d) "Bureau" means the Bank Boards Bureau constituted under Clause 3;

(e) "Chairman" means the Chairman of the Bureau from among the Members appointed under Clause 4;

(f) "Member" means a Member of the Bureau appointed under Clause 4;

(g) "nationalised bank" means a corresponding new bank constituted under Section 3 of the Act;

(h) "Nationalised Banks Scheme" means each of the Nationalised Banks (Management and Miscellaneous Provisions) Scheme, 1970 and the Nationalised Banks (Management and Miscellaneous Provisions) Scheme, 1980;

(2) Words and expressions used but not expressly defined herein shall have the meaning assigned to them in the Act or under the Nationalised Banks Scheme.

CHAPTER II

BANK BOARDS BUREAU

3. Constitution of the Bank Boards Bureau.— (1) The Central Government shall by notification in the Official Gazette, establish for purposes of the Act, the Nationalised Banks Scheme and this [Scheme / Order], a Bureau by the name of the Bank Boards Bureau.

(2) The Members of the Bureau shall be appointed by a selection committee chaired by the Secretary, Department of Financial Services, Ministry of Finance, Government of India and comprising a Deputy Governor of the Reserve Bank and a banker of repute and standing, who should ordinarily have headed the operations of a bank or of a systemically important non-banking financial institution.

(3) Such committee shall have the powers to regulate its own conduct and procedures for purposes of search and selection of the Members of the Bureau, which powers shall not be further delegated.

4. Management of the Bureau.— (1) The Bureau shall consist of three Members, each of whom shall be either serving or shall have served as chairman of any bank.

(2) One of the Members of the Bureau shall be designated as Chairman of the Bureau at the time of his appointment, and he shall act as such and discharge the role stipulated therefor in accordance with the provisions of this [Scheme / Order].

(3) The general superintendence, direction and management of the affairs of the Bureau shall vest in the Members of the Bureau, who may exercise all powers and do all acts and things which may be exercised or done by the Bureau in accordance with the provisions of this [Scheme / Order].

(4) Subject to the foregoing, the Chairman shall have powers of general superintendence, administration, direction, leadership of the affairs of the Bureau.

(5) The head office of the Bureau shall be in Mumbai.

5. Term of office and conditions of service of Members of the Bureau.— (1) The term of office of the Members of the Bureau shall not exceed a period of three years from the date of appointment, and none of the Members shall be eligible for re-appointment. The other conditions of service shall be on such terms as may be prescribed.

(2) Notwithstanding anything contained in sub-Clause (1), the Central Government may terminate the services of any Member earlier on grounds of insanity, insolvency, or conviction of any offence involving moral turpitude.

(3) In the event of physical disability rendering such Member incapable of discharging the role expected of him under this [Scheme / Order], the Central Government may remove such Member after issuance of a notice in writing setting out the grounds for removal and after giving the Member an opportunity of being heard in the matter.

(4) Any Member shall have the right to relinquish office at any time before the expiry of the period specified in sub-Clause (1) by giving to the Central Government written notice of reasons of relinquishment of not less than three months.

6. Meetings.— (1) The Bureau shall meet at such times and places, and shall observe such rules of procedure in regard to the transaction of business at its meetings as the Bureau may notify in writing.

(2) The quorum for any meeting shall be two Members, one of whom shall always be the Chairman.

(3) All questions which come up before any meeting of the Bureau shall be decided by a majority vote of those present and voting, and, in the event of an equality of votes, the decision shall stand adjourned to a meeting to be held with the presence of all Members at such meeting, where the decision would taken by a majority of those present and voting,

(4) In the event of the Bureau comprising only two Members owing to a vacancy in office, the Chairman shall have a second or casting vote.

7. Member not to participate in certain cases.— (1) Any Member, who has any relationship with any person in respect of whom any matter has come up for consideration at a meeting of the Bureau shall as soon as practicable, after relevant circumstances have come to his knowledge, disclose the nature of his relationship at such meeting and such disclosure shall be recorded in the proceedings of the Bureau, and such Member shall not take any part in any deliberation or decision of the Bureau with respect to such matter.

(2) In the Member so recusing from deliberations were the Chairman, the other two Members shall take the decision at a meeting, with one of them acting as Chairman, taking a decision among themselves as to who the Chairman would be.

8. Vacancies, etc., not to invalidate proceedings.— Any vacancy or defect in the constitution of the Bureau, or any defect in the appointment of a person acting as a Member, or any irregularity in the procedure of the Bureau not affecting the merits of the decision shall not invalidate the proceedings or decisions of the Bureau.

9. Officers and employees of the Bureau.— (1) The Bureau may appoint such other officers and employees as it considers necessary for the efficient discharge of its functions under this [Scheme / Order].

(2) The term and other conditions of service of officers and employees of the Bureau appointed under sub-Clause (1) shall be such as may be determined by the Bureau.

CHAPTER III

FUNCTIONS OF THE BUREAU

10. Functions and powers of the Bureau.— (1) The Bureau shall make recommendations to the Central Government in respect of every person to be appointed, or as the case may be, nominated to any Board by the Central Government under Section 9 of the Act or under the Nationalised Banks Scheme by undertaking a search and selection process.

(2) It is clarified for the avoidance of doubt that the recommendations under sub-Clause (1) shall include those for appointment or nomination of whole-time directors and all other directors of any Board under the Act or under the Nationalised Banks Scheme.

(3) In making its recommendation for appointment or nomination to any Board, the Bureau shall have regard to various factors including, without limitation, the specific requirements of skill sets that would complement existing strengths of the relevant nationalised bank, the inadequacies if any that the relevant nationalised bank needs to mitigate, succession planning issues, and the diversity of background and experience of directors on the Board.

(4) The Bureau shall be entitled to engage external professional assistance including availing of services of executive search firms and management consultants, as also accounts and lawyers for discharge of its functions under this [Scheme / Order].

(5) The Members shall not be entitled to delegate their power of making recommendations under sub-Clause (1) to any other person including other employees or officers of the Bureau.

(6) The Bureau shall consider issuing advisories to any nationalised bank setting out its advice on specific areas of corporate governance that need greater attention in such nationalised bank, which shall be tabled and discussed at meetings of the relevant Board.

(7) The Bureau shall maintain an official website on the internet in which it shall publish information about the positions in various Boards that are required to be filled, the positions that are filled based on its recommendations and information about cases where its recommendations have been rejected by the Central Government.

11. Government to be guided by the Bureau.—(1) The Central Government shall be guided by the recommendations made by the Bureau appointing or nominating any person to any Board under the Act and the Nationalised Banks Scheme, and shall ordinarily accept such recommendation.

(2) The Central Government shall be free not to accept the recommendation of the Bureau in respect of any appointment or nomination by passing an order in writing, recording reasons for such rejection.

(3) Every order passed under sub-Clause (2) shall be promptly communicated to the Bureau, which shall publish such order on its official website.

(4) The Central Government may designate the Bureau as the agency to undertake the process of consultation with the Reserve Bank specified in Section 9 of the Act and the Nationalised Banks Scheme, for any appointment, or as the case may be, nomination to any Board.

12. Power to charge fees etc.— (1) The Bureau shall be entitled to charge appropriate fees and charges to the nationalised banks to defray the costs of functioning of the Bureau and to able to discharge its role under this [Scheme / Order], and the nationalised banks shall promptly make over such amount charged by the Bureau.

(2) The Bureau shall function as far as practicable on a self-sustained basis and shall be entitled to charge an initial contribution from each nationalised bank for purposes of funding the Bureau's operations.

13. Plans, returns and reports.— (1) The Bureau shall submit to the Central Government an annual operating plan setting out the amounts needed for its operations for that year, indicating how it intends to meet such costs and expenditure and setting out a request for any grant of funds that may be required from the Central Government.

(2) The Central Government may grant such amount of money as it deems necessary to enable the Bureau to discharge its functions under this [Scheme / Order], having regard to the principle that the functioning of the Bureau should as far as possible be funded by contributions from the nationalised banks and not out of state exchequer.

(3) The Bureau shall furnish to the Central Government at such time and in such form and manner, such returns and statements containing such particulars in regard to the functioning of this [Scheme / Order], as may be prescribed.

CHAPTER IV

MISCELLANEOUS PROVISIONS

14. Power of Central Government to supersede the Bureau.— (1) If at any time the Central Government is of opinion:—

(a) that on account of grave emergency, the Bureau is unable to discharge the functions and duties imposed on it by or under this [Scheme / Order]; or

(b) that as a result of default by the Members in discharging their role under this [Scheme / Order], the financial position of the Bureau has materially weakened and its administration has been substantially and adversely affected;

the Central Government may, by notification in the Official Gazette, supersede the Bureau for such period, not exceeding three months, as may be specified in the notification.

(2) Upon the publication of such notification,—

(a) all the members shall, as from the date of supersession, vacate their offices; and

(b) all the powers and functions of the Bureau shall, until the Bureau is reconstituted, be exercised and discharged by such person or persons as the Central Government may direct in writing;

(3) Within a period of three months from the date of notification of the supersession, the Bureau shall be reconstituted by a fresh appointment in accordance with Clause 3 of this [Scheme / Order].

15. Protection of action taken in good faith.— No suit, prosecution or other legal proceedings shall lie against the Bureau or any Member or its officers or other employee for anything which is done in good faith.

16. Inconsistency, if any, across Schemes.— (1) The provisions of this [Scheme / Order] shall be construed harmoniously with the provisions of the Nationalised Banks Scheme.

(2) In the event of any inconsistency between the provisions of this [Scheme / Order] and the provisions of the Nationalised Banks Scheme, the provisions of this [Scheme / Order] shall prevail.

ANNEXURE 2

Draft Rules under the SBI Act and SBI (Subsidiary Banks) Act

In exercise of powers conferred upon it by Section 49 of the State Bank of India Act, 1955 (23 of 1955) and Section 62 of the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959), the Central Government hereby makes the following Rules namely.—

1. Short title and commencement.— (1) These Rules may be called the Corporate Governance Rules, 2014.

(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

(3) The notes set out along with the provisions of these Rules are an integral part thereof setting out the legislative intent to guide the interpretation of these Rules.

2. Definitions.— (1) In these Rules, unless the context otherwise requires,—

(a) "bank" means the State Bank or any subsidiary bank;

(b) "Board" means the Central Board, the Local Board or as the case may be, the board of directors of any subsidiary bank;

(c) "Bureau" means the Bank Boards Bureau constituted under [Clause 3 of the Scheme / the Order];

[(d) "Order" means the Resolution of the Government of India in the Department of Economic Affairs No. [▪] dated [▪] day of [▪], [2014];]

(e) "SBI Act" means the State Bank of India Act, 1955 (23 of 1955);

(f) "SBI Subsidiary Act" means the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959); and

[(g) "Scheme" means the Nationalised Banks (Corporate Governance) Scheme, 2014].

(2) Words and expressions used but not expressly defined herein shall have the meaning assigned to them in the SBI Act or the SBI Subsidiary Act.

3. Recommendation of appointments and nominations.— (1) For purposes of any nomination or appointment of any individual to the Central Board or Local Board of the State Bank or the board of directors of any subsidiary bank under the SBI Act or the SBI Subsidiary Act, the Central Government shall be guided by recommendations made by the Bureau.

(2) The Central Government shall be guided by the recommendations made by the Bureau appointing or nominating any person to any Board under the SBI Act and the SBI Subsidiaries Act, and shall ordinarily accept such recommendation.

(3) The Central Government shall be free not to accept the recommendation of the Bureau in respect of any appointment or nomination by passing an order in writing, recording reasons for such rejection.

(4) Every order passed under sub-Rule (2) shall be promptly communicated to the Bureau, which shall publish such order on its official website.

4. [Scheme / Order] to apply.— In making its recommendation for any appointment or nomination under these Rules, the Bureau shall discharge its functions and play its role as if the State Bank and every subsidiary bank

were a “nationalised bank” in terms of the [Scheme / Order] and the provisions of the [Scheme / Order] shall *mutatis mutandis* apply to the performance of the Bureau’s role under these Rules.

ANNEXURE 3

Draft Legislation to be passed by Parliament

DRAFT BANKING SECTOR GOVERNANCE ACT, [▪]

[Act [▪] of [▪]]

Statement of Objects and Reasons.—

Premable.—

An Act to consolidate and amend banking laws in India to provide for a framework to enable global standards of corporate governance in all banks in India with appropriate checks and balances in the governance framework; to vest the undertakings of nationalised banks in respective banking companies to be regulated by the Banking Regulation Act, 1949 (10 of 1949) and the Companies Act, 2013 (18 of 2013); to vest the shareholding of the Central Government in such banking companies in a holding company; to repeal and replace the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980); and to provide for matters connected therewith or incidental thereto.

BE it enacted by parliament in the [▪]th Year of the Republic of India as follows.—

CHAPTER I

PRELIMINARY

Short title, extent and commencement.

1. (1) This Act may be called the Banking Sector Governance Act, [▪].

(2) It extends to the whole of India.

(3) This section shall come into force at once and all the remaining provisions of this Act shall come into force on such date as the Central Government may, in consultation with the Reserve Bank, by notification appoint.

(4) A copy of a notification issued under sub-section (3) shall be laid before each House of Parliament at the earliest.

Definitions.

2. (1) In this Act, unless the context otherwise requires,—

(*a*) "appointed day" means such date as the Central Government may, appoint in any notification made under sub-section (3) of section 1 for bringing into effect any provision of this Act;

(*b*) "Bank Investment Company" means the Bank Investment Holding Company Ltd., a company incorporated under the Companies Act to act as a holding company for shareholding of all Banking Companies under this Act;

(*c*) "Bank Nationalisation Acts" means the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980);

(*d*) "Banking Company" means the public limited company to be incorporated under the Companies Act with the name set out in Column 2 of Schedule 1 hereto;

(*e*) “Banking Regulation Act” means the Banking Regulation Act, 1949 (10 of 1949);

(*f*) “Bharatiya Mahila Bank” means the Bharatiya Mahila Bank Ltd., a banking company incorporated under the Companies Act vide certificate of incorporation dated [▪] bearing Registration No. [▪];

(*g*) “Bureau” means the Bank Boards Bureau constituted under **[**the Nationalised Banks (Corporate Governance) Scheme, 2014 framed under Section 9 of each of the Bank Nationalisation Acts / the Resolution of the Government of India in the Department of Economic Affairs No. [▪] dated [▪] day of [▪], [2014];

(*h*) “Companies Act” means the Companies Act, 2013 (18 of 2013);

(*i*) “IDBI Bank” means the IDBI Bank Ltd., a banking company incorporated under the Companies Act vide certificate of incorporation dated [▪] bearing Registration No. [▪].

(*j*) “Income-tax Act” means the Income-tax Act, 1961 (43 of 1961);

(*k*) “Nationalised Bank” means such nationalised bank whose name is set out in Column 1 of Schedule 1 hereto, and which had been constituted as a corresponding new bank constituted under Section 3 of each of the Bank Nationalisation Acts, and includes the State Bank, State Bank Subsidiaries, IDBI Bank and the Bharatiya Mahila Bank;

(*l*) “notification” means a notification published in the Official Gazette;

(*m*) “prescribed” means prescribed by rules made under this Act;

(*n*) “Reserve Bank” means the Reserve Bank of India constituted under the Reserve Bank of India Act, 1934 (2 of 1934);

(*o*) “securities laws” means the provisions of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities Contracts (Regulation) Act, 1956 (42 of 1956), and all rules and regulations made thereunder;

(*p*) “State Bank” means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955);

(*q*) “State Bank Subsidiaries” means the subsidiaries of State Bank carrying on the business of banking in terms of the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);

(2) Words and expressions used and not expressly defined herein but defined in the Banking Regulation Act, 1949 or the Companies Act or [▪] or [▪] shall have the meanings respectively assigned to them under those Acts.

CHAPTER II

VESTING OF NATIONALISED BANKS IN BANKING COMPANIES

Establishment of Banking Companies and Bank Investment Company.

3. (1) With effect from the appointed day, the undertaking of each of the Nationalised Banks other than the Bharatiya Mahila Bank and the IDBI Bank shall transferred to and vest in the Banking Company set out against the name of such Nationalised Bank.

Provided that the Bharatiya Mahila Bank and the IDBI Bank shall be treated as a “Banking Company” established under this Act for all purposes of this Act.

(2) Every Banking Company established hereunder shall be regulated as if such Banking Company had always been issued a license as a “banking company” under the Banking Regulation Act, and the provisions of that Act and of the Companies Act shall be applicable to the operations of such Banking Company notwithstanding anything to the contrary stated in those Acts.

(3) Every Banking Company shall comply with the corporate governance requirements stipulated under securities laws including those in relation to composition of the board of directors, appointment of sub-committees of the board of directors and all related requirements, as if such Banking Company were a listed company regardless of whether its shares are listed on any stock exchange, and disclosures mandated under such requirements to be made to the stock exchange shall be made to the Reserve Bank.

General effect of transfer and vesting.

4. (1) Notwithstanding anything contained in any other law for the time being in force, each of the Banking Companies shall be fully entitled to continue without any interruption to carry on the business of banking in terms of the Banking Regulation Act without having to apply afresh for any license to operate as a banking company under that Act.

(2) The Central Government and every other shareholder of every Nationalised Bank immediately before the appointed day shall be deemed to be a registered shareholder on and with effect from the appointed day as a shareholder of the corresponding Banking Company to the extent of the face value of the shares held by such shareholder.

(3) The undertaking of the Nationalised Bank which is transferred to and vested in the corresponding Banking Company under section 3 shall be deemed to include all business, assets, rights, powers, authorities and privileges and all properties, movable and immovable, real and personal, corporeal and incorporeal, in possession or reservation, present or contingent of whatever nature and wheresoever situate including lands, buildings, vehicles, cash balances, deposits, foreign currencies, disclosed and undisclosed reserves, reserve fund, special reserve fund, benevolent reserve fund, any other fund, stocks, investments, shares, bonds, debentures, security, management of any industrial concern, loans, advances and guarantees given to any person or industrial concern, tenancies, leases and book debts and all other rights and interests arising out of such property as were immediately before the appointed day in the ownership, possession or power of the Nationalised Bank in relation to its undertaking, within or without India, all books of account, registers, records and documents relating thereto and shall also be deemed to include all borrowings, liabilities and obligations of whatever kind within or without India then subsisting of the Nationalised Bank in relation to its respective undertaking.

(4) All contracts, deeds, bonds, guarantees, powers of attorney, other instruments and working arrangements subsisting immediately before the appointed day and affecting a Nationalised Bank shall be of as full force and effect against or in favour of the corresponding Banking Company in which the undertaking of such Nationalised Bank has vested by virtue of this Act and enforceable as fully and effectually as if instead of the Nationalised Bank, the Banking Company had always been named therein or had been a party thereto.

(5) Any proceeding or cause of action pending or existing immediately before the appointed day by or against any Nationalised Bank in relation to its undertaking may, as from the appointed day, be continued and enforced by or against the corresponding Banking Company in which the undertaking of the Nationalised Bank has vested by virtue of this Act as it might have always been capable of being enforced by or against such Banking Company.

(6) Each of the Banking Companies shall be entitled to get the same treatment from all other departments of the Central Government and State Governments and other public sector undertakings for purposes of banking business transacted with the Nationalised Banks prior to the appointed day including without limitation provision of guarantees, deposits, security where any other requirement has been imposed in accordance with law to transact only with Nationalised Banks.

Provisions in respect of officers and other employees of Nationalised Banks

5. (1) Every officer or other employee of any Nationalised Bank (except a director of the Board or the chairman and managing director or any whole-time director) serving in the employment immediately before the appointed day shall, in so far as such officer or other employee is employed in connection with the undertaking which

has vested in a Banking Company by virtue of this Act, become, as from the appointed day, an officer or, as the case may be, other employee of such Banking Company and shall hold his office or service therein by the same tenure, at the same remuneration, upon the same terms and conditions, with the same obligations and with the same rights and privileges as to leave, leave fare concession, welfare scheme, medical benefit scheme, insurance, provident fund, other funds, retirement, voluntary retirement, gratuity and other benefits as he would have held under the Nationalised Bank if its undertaking had not vested in the Banking Company and shall continue to do so as an officer or, as the case may be, other employee of the Banking Company.

(2) Notwithstanding anything contained in the Industrial Disputes Act, 1947(14 of 1947), or in any other law for the time being in force, the transfer of the services of any officer or other employee of the Nationalised Bank to the Banking Company shall not entitle such officer or other employee to any compensation under this Act or under any other law for the time being in force and no such claim shall be entertained by any court, tribunal or other authority.

(3) The officers and other employees who have retired before the appointed day from the service of the Nationalised Bank and are entitled to any benefits, rights or privileges shall be entitled to receive the same benefits, rights or privileges from the Banking Company.

(4) The trust of the provident fund or the gratuity fund of every Nationalised Bank and any other bodies created for the welfare of officers or employees would continue to discharge their functions in relation the Banking Company as was being done prior to the appointed day and any tax exemption granted to the provident fund or the gratuity fund or pension fund would continue to be available after the appointed day.

(5) Notwithstanding anything contained in this Act or in the Companies Act, or in any other law for the time being in force including regulations under any Act or Schemes under the Bank Nationalisation Acts, no director of the Board, chairman and managing director or any wholetime director or any other person entitled to manage the whole or substantial part of the business and affairs of the Nationalised Bank shall be entitled to any compensation for loss of office or for the premature termination of any contract of management entered into by him with the Nationalised Bank.

Benefit of exemptions, concessions etc.

6. (1) With effect from the appointed day, all concessions, licenses, benefits, privileges and exemptions granted to any Nationalised Bank in connection with the affairs and business of the Nationalised Bank under any law for the time being in force shall be deemed to have been granted to the corresponding Banking Company.

(2) Where any exemption from, or any assessment with respect to any direct or indirect tax has been granted or made to a Nationalised Bank under any fiscal statute, or any benefit by way of set off or carry forward of any unabsorbed depreciation or investment allowance or other allowance or loss has been extended or is available to a Nationalised Bank under the Income-tax Act, such exemption, assessment or benefit shall continue to have effect in relation to the corresponding Banking Company.

(3) Where any payment made by the Nationalised Bank is exempted from deduction of tax at source under any provision of the Income-tax Act, such exemption will continue to be available as if the provisions of the said Act made applicable to the Nationalised Bank were operative in relation to the corresponding Banking Company.

(4) The transfer and vesting of the undertaking of every Nationalised Bank in the corresponding Banking Company, and the transfer and vesting of shares of the Banking Company in the Bank Investment Company under this Act shall not be construed as a transfer within the meaning of the Income-tax Act or any other law for the time being in force and all consequences of such transfer and vesting shall be tax-neutral.

Shares, bonds and debentures to be deemed to be approved securities.

7. Notwithstanding anything contained in any other law for the time being in force, the shares, bonds and

debentures of the Banking Company shall be deemed to be approved securities for the purposes of the Indian Trusts Act, 1882(2 of 1882) and the Insurance Act, 1938(4 of 1938).

CHAPTER III

ESTABLSHMENT OF BANK INVESTMENT COMPANY

Creation of Bank Investment Company and vesting of shareholdings.

8. (1) With effect from the appointed day, simultaneous with the transfer and vesting of the undertaking of the Nationalised Banks in the Banking Companies, the holding of the Central Government of any securities issued by any Nationalised Bank including equity shares, preference shares, bonds and other instruments shall stand transferred to and vest in the Bank Investment Company.

(2) On and from the appointed day, —

(*a*) any reference to the Bureau in any contract or other instrument shall be deemed as a reference to the Bank Investment Company;

(*b*) all properties and assets, movable and immovable, of, or belonging to, the Bureau shall vest in the Bank Investment Company;

(*c*) all rights and liabilities of the Bureau shall be transferred to, and be the rights and liabilities of, the Bank Investment Company;

(*d*) without prejudice to the provisions of clause (*c*), all debts, obligations and liabilities incurred, all contracts entered into and all matters and things engaged to be done by, with or for the Bureau immediately before that appointed day, for or in connection with the purpose of the said Bureau shall be deemed to have been incurred, entered into, or engaged to be done by, with or for, the Bank Investment Company;

(*e*) all sums of money due to the Bureau immediately before that date shall be deemed to be due to the Bank Investment Company;

(*f*) all suits and other legal proceedings instituted or which could have been instituted by or against the Bureau immediately before the appointed day may be continued or may be instituted by or against the Bank Investment Company; and

(*g*) every employee holding any office under the Bureau immediately before that date shall hold his office in the Bank Investment Company by the same tenure and upon the same terms and conditions of service as respects remuneration, leave, provident fund, retirement and other terminal benefits as he would have held such office if the Bureau had not been established and shall continue to do so as an employee of the Bank Investment Company.

(3) Notwithstanding anything contained in the Industrial Disputes Act, 1947 (14 of 1947), or in any other law for the time being in force, absorption of any employee by the Bank Investment Company in its regular service under this section shall not entitle such employee to any compensation under that Act or other law and no such claim shall be entertained by any court, tribunal or other authority.

Functions of the Bank Investment Company.

9. (1) The Bank Investment Company shall play the role of a professional holding company that seeks to protect the value of its investments in portfolio companies whose shares and securities it holds and shall exercise the powers of a shareholder under the Companies Act so as to protect the value of its investments in the Banking Companies.

(2) Without prejudice to the generality of the foregoing, the measures that may be taken by the Bank Investment Company may include without limitation:—

(*a*) search, identification and selection of appropriate persons to be appointed as wholetime directors and non-executive directors on for the boards of directors of the Banking Companies;

(*b*) approval of the managerial remuneration for personnel of the Banking Companies under the Companies Act;

(*c*) provision of guidance and mentoring to the boards of directors of the Banking Companies to enable them to adopt best practices with governance standards and eventually develop the capacity to guide the functioning and operation of the businesses of the Banking Companies;

(*d*) approval of the managerial remuneration for personnel of the Banking Companies under the Companies Act;

(*e*) making recommendations to the Central Government in respect of every person to be appointed, or as the case may be, nominated to any board of directors of the Bank Investment Company by undertaking a search and selection process;

(3) In taking any decision on appointment of a director on the board of any Banking Company, the Bank Investment Company shall have regard to various factors including, without limitation, the specific requirements of skill sets that would complement existing strengths of the relevant Banking Company, the inadequacies if any that the relevant Banking Company needs to mitigate, succession planning issues, and the diversity of background and experience of directors on the board of directors of such Banking Company.

(4) The Bank Investment Company shall be entitled to engage external professional assistance including availing of services of executive search firms and management consultants, as also accounts and lawyers for discharge of its functions under this Act.

(5) The Bank Investment Company shall consider issuing advisories to any Banking Company setting out its advice on specific areas of corporate governance that need greater attention in such Banking Company, which shall be tabled and discussed at meetings of the board of directors of the relevant Banking Company.

(6) The articles of association of the Bank Investment Company shall conform to the framework set out in Schedule 2 hereto and shall contain provisions that address the objectives set out therein.

Government to be guided by Bank Investment Company.

10. (1) Until such time the Central Government owns more than 50 per cent of the equity share capital of the Bank Investment Company, the Central Government shall be generally guided by the recommendations made by the Bank Investment Company in the matter of any appointment to the board of directors of the Bank Investment Company under this Act that requires approval of the appointments committee of the Union Cabinet, and the Central Government shall ordinarily accept such recommendation.

(2) It is clarified for the avoidance of doubt that the Central Government shall be free not to accept the recommendation of the Bank Investment Company in respect of any appointment or nomination by passing an order in writing, recording reasons for such rejection.

(3) Every order passed under sub-Clause (2) shall be promptly communicated to the Bank Investment Company, which shall publish such order on its official website.

(4) Upon the ownership of the Central Government in the equity share capital of the Bank Investment Company falling to below 50 per cent, the Bank Investment Company shall be free to make such appointments without reference to the Central Government.

Devolution of empowered recommendations to Banking Companies.

11. (1) The Bank Investment Company may, in consultation with the Reserve Bank, upon being satisfied that the boards of Banking Companies are functioning well and have acquired a standing and experience of being well

governed as institutions, by notification appoint such date by which the boards of directors of any Banking Company would be empowered to make recommendations and nominations for appointment of directors to their respective boards of directors and to propose the same to their shareholders for approval at a general meeting.

(2) Upon such notification, notwithstanding anything contained in this Act, the boards of directors of such Banking Company shall be entitled to nominate and recommend any appointment to its board of directors, whether in an executive capacity or otherwise, and the Bank Investment Company would be entitled to decide at its own discretion on whether to vote for or against such nomination, and may use its powers as a shareholder to vote for or against such nomination.

(3) Every notification made under sub-section (1) shall be laid by the Central Government, as soon as may be after it is made, before each House of Parliament.

Management of the Bank Investment Company.

12. (1) The general management, superintendence and direction of the Bank Investment Company shall vest in its board of directors comprising,—

(*a*) a chief executive officer;

(*b*) a non-executive chairman;

(*c*) at least three independent directors, with skill and experience in banking and investment; and

(*d*) such number of wholetime directors as the board of directors determines is necessary for effective function of the Bank Investment Company.

(2) Each of the chief executive officer and other wholetime directors shall have been a professional commercial banker or a person with experience of at least [▪] years as an institutional strategic equity investor managing investments in companies involved in the banking and financial service sector, and shall be nominated by a search and selection process to be conducted by the board of the Bank Investment Company.

(3) The non-executive chairman shall be a person who shall have served as chairman of any commercial bank and in assessing and protecting strategic equity investments, and shall be nominated by the Central Government.

(4) The independent directors shall be selected by the board of directors of the Bank Investment Company and shall be appointed as such until such time the Central Government owns more than 50 per cent of the equity share capital of the Bank Investment Company.

Provided that if the Central Government's ownership of the equity share capital of the Bank Investment Company falls below 50 per cent, such directors shall be appointed in accordance with the provisions of the Companies Act.

(5) No person shall be eligible to be appointed as a director of the Bank Investment Company if he is a director or employee of any entity whether in India or outside, that has material ownership in any bank in India.

(6) The chief executive officer and the non-executive chairman of the Bank Investment Company shall be appointed by a selection committee chaired by the Secretary, Department of Financial Services, Ministry of Finance and comprising a Deputy Governor of the Reserve Bank and a banker of repute and standing, who should ordinarily have headed the operations of a bank or of a systemically important non-banking financial institution.

(6) Such committee shall have the powers to regulate its own conduct and procedures for purposes of search and selection of directors of the Bank Investment Company, which powers shall not be further delegated.

Term of office and conditions of service.

13. (1) The term of office of the directors of the Bank Investment Company shall not exceed a period of [▪] years from the date of appointment.

(2) Notwithstanding anything contained in sub-Clause (1), the Central Government may terminate the services of any director earlier on grounds of insanity, insolvency, or conviction of any offence involving moral turpitude.

(3) In the event of physical disability rendering a director incapable of discharging the role expected of him under this Act, the Central Government may remove such director after issuance of a notice in writing setting out the grounds for removal and after giving the director an opportunity of being heard in the matter.

(4) Any director may relinquish office at any time by giving to the Central Government written notice of reasons of relinquishment of not less than three months.

(5) Subject to the foregoing, the provisions of the Companies Act shall govern the functioning, the administration and the operations of the Bank Investment Company.

(6) Subject to compliance with the Companies Act, no vacancy or defect in the constitution of the board of directors of the Bank Investment Company , or any defect in the appointment of a person acting as a director, or any irregularity in the procedure of the Bank Investment Company not affecting the merits of the decision shall invalidate its proceedings or decisions.

(7) The Bank Investment Company may appoint such other officers and employees as it considers necessary for the efficient discharge of its functions under this Act.

(8) The term and other conditions of service of officers and employees of the Bank Investment Company shall be such as may be determined by the board of directors of the Bank Investment Company.

Power of Central Government to supersede the board of directors.

14. (1) If at any time the Central Government is of opinion:—

(*a*) that on account of grave emergency, the Bank Investment Company is unable to discharge the functions and duties imposed on it by or under this Act; or

(*b*) that as a result of default by the Bank Investment Company in discharging its role under this Act, the financial position of the Bank Investment Company has materially weakened and its administration has been substantially and adversely affected;

the Central Government may, by notification in the Official Gazette, supersede the board of directors for such period, not exceeding three months, as may be specified in the notification.

(2) Upon the publication of such notification,—

(*a*) all the directors shall, as from the date of supersession, vacate their offices; and

(*b*) all the powers and functions of the Bank Investment Company shall, until the board of directors of the Bank Investment Company is reconstituted, be exercised and discharged by such person or persons as the Central Government may direct in writing;

(3) Within a period of three months from the date of notification of the supersession, the board of directors of the Bank Investment Company shall be reconstituted by a fresh appointment in accordance with this Act.

(4) Every notification made under sub-section (1) shall be laid, as soon as may be after it is made, before each House of Parliament.

CHAPTER IV

MISCELLANEOUS

Government Ownership.

15. (1) The Central Government shall be entitled to attract private investment in the equity share capital of the Bank Investment Company and shall initially own at least 51 per cent of the equity share capital of the Bank Investment Company.

(2) Any fresh issue of shares by the Bank Investment Company or a transfer of shares held by the Central Government such that the residual equity shareholding of the Central Government shall be diluted to below 50 per cent in the share capital of the Bank Investment Company shall require a notification by the Central Government, which shall be tabled in each House of Parliament at the earliest.

(3) Any fresh issue of shares by any Banking Company or a transfer of shares held by the Bank Investment Company such that the residual equity shareholding of the Bank Investment Company shall be diluted to below 50 per cent in the share capital of any Banking Company shall require a notification by the Bank Investment Company, which shall be tabled in each House of Parliament at the earliest.

(4) Any future involvement of the Central Government in the business of banking shall be conducted only by way of the Bank Investment Company promoting or acquiring such banking business and holding the same in the form of a banking company under the Companies Act.

(5) Any director nominated by the Bank Investment Company to the board of directors of any Banking Company shall be regarded as a nominee by the promoter for purposes of securities laws.

(6) Notwithstanding anything contained herein, if the Central Government's ownership of the equity share capital of the Bank Investment Company falls below 50 per cent or prior to such event the Bank Investment Company's ownership of any Banking Company were to fall below 50 per cent, appointments of directors in the Bank Investment Company or as the case may be, such Banking Company shall be made in accordance with the provisions of the Companies Act.

Financial resources.

16. (1) The Bank Investment Company shall submit to the Central Government an annual operating plan setting out the amounts needed for its operations for that year, indicating how it intends to meet such costs and expenditure and setting out a request for any grant of funds that may be required from the Central Government.

(2) The Central Government may grant such amount of money as it deems necessary to enable the Bank Investment Company to discharge its functions, having regard to the principle that its functioning should as far as possible be funded by its own earnings of dividends and capital gains made from its investments in the Banking Companies and not out of state exchequer.

(3) Notwithstanding anything contained in the Companies Act, the Bank Investment Company shall be entitled to charge appropriate fees and charges to the Banking Companies to defray the costs of its functioning and to able to discharge its role under this Act, and the Nationalised Banks shall promptly make over such amount charged.

(4) The board of directors of the Bank Investment Company may adopt a dividend policy for payment of dividends by it to its shareholders.

(5) The Bank Investment Company shall furnish to the Central Government at such time and in such form and manner, such returns and statements containing such particulars in regard to the functioning of this Act, as may be prescribed.

Protection of action taken in good faith.

17. Notwithstanding anything contained in any other law, no suit, prosecution or other legal proceedings shall lie against any employee or director of any Banking Company and the Bank Investment Company in relation to any commercial business decision taken by such person unless it can be demonstrated that such employee or director personally made a wrongful gain for taking such decision, and a technical breach of procedure shall not be the basis for initiating criminal prosecution.

Provisions to override conflicting laws.

18. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any enactment other than this Act or in any instrument having effect by virtue of any enactment other than this Act.

Application of other laws not barred.

19. The provisions of this Act shall be in addition to, and not in derogation of the provisions of any other law for the time being in force.

Substitution in Acts, rules, regulations.

20. In any other Act, rule or regulation or any other provision of law, without any further act, deed or thing having to be done,—

(*a*) all references to any Nationalised Bank either generally or specifically shall be deemed to be a reference to the corresponding Banking Company under this Act;

(*b*) all references to the Bureau either generally or specifically shall be deemed to be a reference to the Bank Investment Company.

Power to make Rules.

21. (1) The Central Government may, by notification, make rules for carrying out the provisions of this Act.

(2) Every rule made under this section shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

Power to remove difficulties.

22. (1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government, for a period of three years from the issuance of a notification to give effect to this Act, may by notification, make provisions from time to time, not inconsistent with the provisions of this Act as may appear to it to be necessary or expedient for removing the difficulty.

(2) Every notification made under sub-section (1) shall be laid, as soon as may be after it is made, before each House of Parliament.

Repeal and savings.

23. (1) On the appointed day, each of the following Acts shall stand repealed:—

(a) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970);

(b) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980); and

(c) the State Bank of India Act, 1955 (23 of 1955); and

(d) the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959).

(2) Notwithstanding such repeal, anything done or any action taken under the Bank Nationalisation Acts shall be deemed to have been done or taken under the corresponding provisions of this Act and the provisions of the General Clauses Act, 1897 (10 of 1897) shall be applicable.

(3) Upon such repeal, without any further act, deed or thing to be done, all references to the term "corresponding new bank" in the Banking Regulation Act shall be deemed to be a reference to a "Banking Company" under this Act.

SCHEDULE 1

(*See clauses (d) and (k) of sub-section (1) of section 2*)

[Columnar Arrangement of Nationalised Banks under the Banks Nationalisation Act, and the Banking Companies they would become under this Act]

COLUMN 1	**COLUMN 2**
Central Bank of India	Central Bank of India Ltd.
Bank of India	Bank of India Ltd.
Punjab National Bank	Punjab National Bank Ltd.
Bank of Baroda	Bank of Baroda Ltd.
UCO Bank	UCO Bank Ltd.
Canara Bank	Canara Bank Ltd.
United Bank of India	United Bank of India Ltd.
Dena Bank	Dena Bank Ltd.
Syndicate Bank	Syndicate Bank Ltd.
Union Bank of India	Union Bank of India Ltd.
Allahabad Bank	Allahabad Bank Ltd.
Indian Bank	Indian Bank Ltd.
Bank of Maharashtra	Bank of Maharashtra Ltd.
Indian Overseas Bank	Indian Overseas Bank Ltd.
Andhra Bank	Andhra Bank Ltd.

Corporation Bank	Corporation Bank Ltd.
New Bank of India	New Bank of India Ltd.
Oriental Bank of Commerce	Oriental Bank of Commerce Ltd.
Punjab and Sind Bank	Punjab and Sind Bank Ltd.
Vijaya Bank	Vijaya Bank Ltd.
State Bank of Bikaner	State Bank of Bikaner Ltd.
State Bank of Indore	State Bank of Indore Ltd.
State Bank of Mysore	State Bank of Mysore Ltd.
State Bank of Patiala	State Bank of Patiala Ltd.
State Bank of Travancore	State Bank of Travancore Ltd.
State Bank of Hyderabad	State Bank of Hyderabad Ltd.
State Bank of Saurashtra	State Bank of Saurashtra Ltd.

SCHEDULE 2

(*See sub-section (6) of section 9*)

[Framework of objectives to be addressed in articles of association of the BIC]

1. The Bank Investment Company should formulate an initial Investment Mandate for approval by the Central Government and any modification thereof shall be subject to Central Government approval.

2. Consistent with the Investment Mandate, the board of directors of the Bank Investment Company will formulate a Business Plan within such timeframe as set out in the Articles of Association.

3. Thereafter, all Business Plans, as well as amendments and modifications thereto shall be the responsibility of the board of directors of the Board Investment Company, with the Central Government playing the role as a shareholder.

4. The board of directors shall be obligated to articulate an investment strategy for further acquisitions or disposal of investments in Banking Companies, bearing in mind at all times that such activity should conform to the overall objective of protecting and creating value for the taxpayer as a shareholder and, where applicable, as provider of financial support, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition.

5. Enable the board of directors of the Banking Companies to develop their respective business plans and to enter into relationship agreements with them if necessary to address specific areas of weaknesses that need to be addressed by them.

6. The Bank Investment Company will manage the investments in Banking Companies on a commercial basis and will not intervene in day-to-day management decisions (including with respect to individual lending or remuneration decisions.

7. The nature of the Bank Investment Company's engagement with the Banking Companies will be proportionate to the investment interest in such Banking Company. For example, with Banking Companies in which the entire share capital is held by the Bank Investment Company, it would actively engage in a manner similar to that in which a financial sponsor would engage with a wholly-owned portfolio company. With listed subsidiaries, the Bank Investment Company will engage actively with the Banking Company in accordance with best institutional shareholder practice.

8. It will be ensured at all times that the listed Banking Companies will continue to be separate economic units with independent powers of decision and, in particular, will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets).

9. The Bank Investment Company will put in place robust barriers which are monitored and adhered to by its personnel and enforced by its board of directors to ensure that commercial information relating to any Banking Company is not exchanged with another Banking Company.

10. The Bank Investment Company shall have due regard to the need to comply with competition law requirements and will actively watch out for and pre-empt any anti-competitive behaviour by the Banking Companies in order to remain compliant with law applicable to competition.

11. The Bank Investment Company shall formulate compliance policies and get the Banking Companies to adhere to them and sign up to codes of conduct to ensure the best practices and highest standards of compliance with all applicable laws including, without limitation, securities laws, competition laws and banking regulations.