Corporate Governance in Indian Banking Sector: Problems and Best Practices

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Abstract

Banks constitute the largest financial intermediaries in the world and play a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking Sector. The Indian banking system is among the healthier performers in the world. In the liberalized economic environment and integration of the country, in to world market the corporate sector in India at present cannot ignore the importance of Corporate Governance. The Corporate Governance philosophy of banks has to be based on pursuit of sound business ethics and strong professionalism that aligns the interests of all stakeholders and the society.

Strengthening of public confidence in banks is a vital requirement. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital efficiency are vital for success & continued survival of banks. The conclusion is that sound Corporate Governance would lead to effective & more meaningful supervision and could contribute to a collaborative working relationship between bank management & bank supervisors. Banks need to ensure good Corporate Governance in order to achieve excellence, transparency & for maximization shareholders value & wealth. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business, commitment to better customer service, adequate automation and proactive policies, banks will definitely be able to grapple with these challenges and convert them into opportunities.

Keywords : Corporate Governance, Banking, Problems of Banking Sector, Corporate Governance Practices

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**Introduction**

Banks constitute the largest financial intermediaries around the world and possess stupendous powers of leverage. Unlike in the corporate world, authorities like RBI and the government play a direct role in bank governance through bank regulation and supervision. This role is justified by the need to ensure systemic stability, financial stability and deposit insurance liability considerations. Banks enjoy the benefit of high leverage with the downside protection of deposit insurance which weakens their incentives for strong management monitoring. While a ubiquitous form of corporate control and concentrated ownership will raise new barriers to effective corporate governance, large investors may manipulate the firm contrary to the broad interests of the bank and other stakeholders.

Banking system plays a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Indian banking industry, the backbone of the country economy, has always played a key role in preventing the economic catastrophe from reaching terrible volume in the country. The Indian banking system is among the healthier performers in the world. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital efficiency are vital for success & continued survival of banks. In the liberalized economic environment and integration of the country, in to world market the corporate sector in India at present cannot ignore the importance of Corporate Governance. Corporate Governance is now an issue and important factor that can be used as tool to maximize wealth of shareholders of a corporate. Corporate Governance aims are the Vision, Values and Visibility.
Corporate Governance in Indian Context

In the Indian context, the need for corporate governance has been highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991 such as the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum. From the beginning of 1980s, situations have changed in India. There have been wide ranging changes has taken place in both the laws and the regulations in the field of corporate law and the capital market. As a result of several scams in India a need has arisen to bring reforms, in response to that, reforms began in 1991 in India. The most important event in the field of investor protection in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992. Corporate governance is a multifaceted subject. An important theme of corporate governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare. In India the concept of corporate governance is gaining importance because of two reasons.

- After liberalization, there has been institutionalization of financial markets, FIIs and FIs became dominant players in the stock markets. The market began to discriminate between wealth destroyers. Corporate governance is a critical by product of market discipline.
Another factor is the increased role being played by the private sector. Companies are realizing that investors love to stay with those corporate that create values for their investors. This is only possible by adopting fair, honest and transparent corporate practices.

Corporate Governance in Banks

Corporate Governance has become very important for banks to perform and remain in competition in this era of liberalization and globalization. Banks in a broad sense are institutions whose business is handling other people’s money. A Joint stock bank also known as Commercial Bank which is nothing but a company whose business is banking. Protecting the interest of depositors becomes a matter of paramount interest to banks.

Banking is the crucial factor effecting economic development of an economy. It is the lifeblood of a country. It is responsible for the flow of credit and for maintaining the financial balances of the economy. In India, since the nationalization process banks emerged as a tool of economic development along with social justice.

In banking parlance, the Corporate Governance refers to conducting the affairs of a banking organization in such a manner that gives a fair deal to all the stake holders i.e. shareholders, bank customers, regulatory authority, society at large, employees etc. The significance of corporate governance in banking sector weighs very much due to very nature of banking transactions.

Need of Corporate Governance in Banking Sector

Banks in India are facing increasing competition, within and outside India, both in terms of markets for its products and for sources of fund. It has, therefore become necessary for banks to constantly
reengineer, to provide the products and services to suit the ever changing requirements, to accelerate the speed with which the transactions are completed and to constantly evaluate and provide training to the workforce update the knowledge and impress upon them the necessity to have a professional and competitive approach.

In order to meet the statutory need of having a sound Capital Adequacy requirements, banks are accessing the Capital Market at regular intervals. Hence the Banks need to stimulate the interest of investors at all times. Investors believe that a bank with good governance will provide them a safe place for investment and also give better returns. Good Corporate Governance is, therefore, an important factor in a competitive environment.

Investors, customers, employees and vendors have all become more discerning and are demanding greater transparency and fairness in all dealings. To attract and retain the commitment of investors, Customers, employees, Banks should ensure that they match the global benchmarks in Corporate Governance practices.

Another important factor in banking industry in developing countries is that banks are mostly owned by government. In such situation, banks are mostly guided by government bodies and many laws based on stereotype procedures. The accountability idea is less apparent as the concept of government job discourages the spirit of competition. The need for corporate governance in developing, emerging and transitional economies not only arises from resolving problems of ownership and control, but also from ensuring transparency in achieving the desired goal of corporate governance. In many cases, developing and emerging economies are beset with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing. Ownership pattern, regulatory environment, societal pressure (on the developmental role of banks) and the broad structure would be the key elements in the design of a governance framework of banking. While government ownership does provide core strength to
banks, the structural inefficiencies and lack of management autonomy appears to have weakened the ability of our banks (Public sector) to compete effectively in the current market situation.

Banks and financial institutions have been making pivotal contributions over the years to nation’s economic growth and development. Government-owned (Public Sector) banks have played a major role in economic development. During the last few years, these institutions are slowly getting corporatized and consequently corporate governance issues in banks assumes greater significance in the coming years. Considering the importance of banking sector the practice of corporate governance and how it helps banking industry in India in terms of bringing more transparency and overall growth of banking sector

Corporate governance of banks is an essential element of a country’s governance architecture. It can have systemic financial stability implications and shape the pattern of credit distribution and overall supply of financial services. Hence the necessity and importance of enforcing effective corporate governance in the banking sector

**Evolution of Corporate Governance of Banks in India**

In the pre-reform era, there were very few regulatory guidelines covering corporate governance of banks. This was reflective of the dominance of public sector banks and relatively few private banks. That scenario changed after the reforms in 1991 when public sector banks saw a dilution of government shareholding and a larger number of private sector banks came on the scene. How did these changes shape the post-reform standards of corporate governance?

1. **Customer Service**

The competition brought in by the entry of new private sector banks and their growing market share forced banks across board to pay greater attention to customer service. As customers were now able
to vote with their feet, the quality of customer service became an important variable in protecting, and then increasing, market share.

2. **Towards Corporate Governance**

Post-reform, banking regulation shifted from being prescriptive to being prudential. This implied a shift in balance away from regulation and towards corporate governance. Banks now had greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. The boards of banks had to assume the primary responsibility for overseeing this. This required directors to be more knowledgeable and aware and also exercise informed judgment on the various strategy and policy choices.

3. **Listing Requirements of SEBI**

Two reform measures pertaining to public sector banks - entry of institutional and retail shareholders and listing on stock exchanges - brought about marked changes in their corporate governance standards. Directors representing private shareholders brought new perspectives to board deliberations, and the interests of private shareholders began to have an impact on strategic decisions. On top of this, the listing requirements of SEBI enhanced the standards of disclosure and transparency.

4. **Large Autonomy**

To enable them to face the growing competition, public sector banks were accorded larger autonomy. They could now decide on virtually the entire gamut of human resources issues, and subject to prevailing regulation, were free to undertake acquisition of businesses, close or merge unviable branches, open overseas offices, set up subsidiaries, take up new lines of business or exit existing ones, all without any need for prior approval from the Government. All this meant that greater autonomy to the boards of public sector banks came with bigger responsibility.

5. **Structural Reforms**
A series of structural reforms raised the profile and importance of corporate governance in banks. The structural reform measures included mandating a higher proportion of independent directors on the boards; inducting board members with diverse sets of skills and expertise; and setting up of board committees for key functions like risk management, compensation, investor grievances redressal and nomination of directors. Structural reforms were furthered by the implementation of the Ganguly Committee recommendations relating to the role and responsibilities of the boards of directors, training facilities for directors, and most importantly, application of ‘fit and proper’ norms for directors.

**Issues Relating to Corporate Governance of Banks in India**

1. **Banks play a vital Part of Country’s Economy**

   Among other features, the most important one is the fact that banks form an integral part of the economy of the country, and any failure in a bank might have a direct bearing on the financial health of the country. Banks, help in channelizing people’s saving.

2. **The Liquidity Production Role of Banks**

   The capital structure of bank is unique in two ways. First, banks tend to have very little equity relative to other firms. Second, banks’ liabilities are largely in the form of deposits, which are available to creditors/depositors on demand, while their assets often take the form of loans that have longer maturities. Thus, the principle attribute that makes banks as financial intermediaries “special” is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy. The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run.
3. Funding Pattern of Banks
The next important driver of a good corporate governance stems from their funding patterns. Banks, by their basic definition are highly leveraged financial institutions, with the equity capital of the shareholders being reduced to a miniscule proportion of loan capital in the form of borrowing and deposits of deposits from customers of the bank. As a result of this, the stakeholders in banks, (mainly the depositors and lenders) have a rightful claim of accountability from the banks and their boards.

4. Control function in Banks
Control functions in banks deal with internal frauds as well as external frauds. The former relates to situations where the banks own personnel indulge in corrupt and unethical practices. The latter deals with situations where the customers of the bank try to seek for malpractice. The incidents of the external frauds are so devastating that special attention is being mandated both for their prevention as well as their post scenario analysis. In this connection it is important to remind of the COSO framework that was framed with this intention in mind.

5. Failure to Comply With Stipulated Norms
Failing to comply with stipulated norms can be one of the challenging issues of Corporate Governance framework. With Banks being under intense watch of the central bank as well as other regulatory bodies, it is a common observation, that most failures (crashes) in banks have occurred due to compliance failure situations. With a lot of reports and norms, being introduced (The Basel II norms being the latest of them), failure to adhere to the regulatory norms have never reduced. At this juncture, it becomes essential to discuss as to what roles the Governments have relating Governance issues in banks and what is the necessity of Government intervention in banks.

6. Asset Structure and Loyalty Problems
The presence of a federal insurance fund also increases the risk of fraud and self-dealing in the banking industry by reducing incentives for monitoring. In the 1980s, it was estimated that fraud and
self-dealing transactions were “apparent” in as many as one-third of today’s bank failures. A similar statistic shows that between 1990 and 1991, insider lending contributed to 175 of 286 bank failures. Such behavior, is of course, a possibility in any large firm, since it is inefficient for the owners to monitor all employees at all same times. These sorts of problems are particularly acute in financial institutions, however, because of the large portion of their assets held in highly liquid form.

7. **Bank Ownership**

Another issue concerns ownership. There is typically a divergence between the interests of shareholders and of depositors. Shareholders want profits to be maximized by taking on greater risk; depositors have an overriding preference for the safety of their deposits and hence for lower risk. At the same time, depositors have little say in the governance of banks whereas the shareholders’ say is very pronounced. Within the shareholder group, the extent of control exercised by promoter shareholders too is an important determinant of the effectiveness of corporate governance. As some recent instances demonstrated, such excessive influence of promoters can turn the board into a mouthpiece of the promoter to the detriment of the interests of all other stakeholders.

Another way to look at the issue of ownership is in terms of public vs. private ownership. If banks are publicly owned, issues of conflict of interest between shareholders and depositors get mitigated. Public ownership of banks would also inspire confidence in the financial system. On the other hand, an important question is whether effective and autonomous corporate governance is compatible with public ownership of banks. The question arises because publicly owned banks render accountability to the government and to the democratic institutions. The government judges them on criteria quite different from those used by the market.

Diversified ownership and ‘fit and proper’ status of shareholders are other important determinants of corporate governance. The Reserve Bank’s guidelines on ownership and governance in private sector banks, issued in February 2005, were aimed at ensuring that ownership and control of banks
are well diversified. The Reserve Bank has been consistently following up with banks having concentrated ownership to ensure adherence to the prescribed limits in a time bound manner. Similarly, to ensure ‘fit and proper’ status of large shareholders, acknowledgement from Reserve Bank is mandatory for any acquisition of shares in private sector banks resulting in a shareholding of 5 per cent or more of the total paid up capital of the bank. Having said that, it must be acknowledged that evaluating ‘fit and proper’ is far from being a science; it involves a considerable amount of judgment. Moreover, ‘fit and proper’ is a onetime exercise, not repeated unless new information comes in. These limitations need to be recognized. As we contemplate allowing corporate to promote banks, there is need for changes in statutes and regulations to address these concerns.

8. Accountability, Transparency and Ethics

The separation of ownership and management can create conflict of interest if there is a breach of trust by managers on account of intention, omission, negligence or incompetence. This can be taken care of by making boards more accountable to all stakeholders and making their functioning transparent.

The failure on the scale we saw during the recent global financial crisis is also reflective of poor ethical standards in banks. Almost all the complex gamut of causes of the crisis relate to how the financial system operated. The behavior of actors across the chain of the financial sector was influenced by the opportunity for making quick profit rather than by fair, ethical and moral standards. Such behavior was not only not checked, but was even encouraged.

Boards of banks and financial institutions have to be conscious of their obligation not to hold the larger public interest hostage to their private profit motive.

9. Compensation

Compensation in the banking sector has been another high profile issue post-crisis. It is now widely acknowledged that the faulty incentives framework underlying banks compensation structures in the
advanced countries fuelled the crisis. The performance-based compensation of bank executives is typically justified on the ground that banks need to acquire and retain talent. Bank executives were motivated by short-term profits even if it compromised long-term interests. The Financial Stability Board (FSB) has since evolved a set of principles to govern compensation practices, and the Basel Committee has developed a methodology for assessing compliance with these principles. The proposed framework involves increasing the proportion of variable pay, aligning it with long-term value creation and instituting rearrangement and recover clauses to offset future losses caused by the executive.

Another relevant aspect is the compensation of non-executive directors on the board. There is a view, also articulated in the Government of India’s Corporate Governance Voluntary Guidelines 2009, that companies should have the option of giving a fixed contractual remuneration, not linked to profits, to non-executive directors. In the banking sector, non-executive directors are typically compensated through sitting fees, except non-executive chairmen who are paid a regular remuneration.

The question is whether non-executive directors of banks should also be paid a regular or a fixed contractual remuneration. This is probably a good concept, but difficult to implement in practice. Typically, in banks, the outcomes of risks taken become manifest after a long gap. While it is possible to align compensation of executives to the risks since they are long-term employees, it is more problematic in the case of non-executive directors who serve for relatively shorter periods and have term limits. Furthermore, unlike whole-time executive directors, non-executive directors function collectively as a part of the board and committees of boards making it difficult to apportion responsibility on them individually. Notwithstanding these implementation issues, we need to debate on how to align the compensation of non-executive directors to the outcomes of corporate governance.
Best Practices of Corporate Governance in Banks

Good governance can be built based on the business practices adopted by the board of directors and management. Many bank failures in the past have been attributed to inadequate and insufficient management which enabled the banks to accept low quality assets and assume additional risks that extend beyond the level appropriate for the banks’ capacity. For ensuring corporate governance in banks the Banking Sector needs:

1. To realize that the times are changing

The issue of corporate governance has gained attention only in the recent times. Therefore, even the smallest banks need to focus on corporate governance restructuring. This is due to the apparent lack of integrity and values in operation of some large corporations.

2. To establish an Effective, Capable and Reliable Board of Directors

Establishing an effective, capable and reliable board of directors requires involving well qualified and successful individuals with integrity. This implies that a majority of banks’ board of directors should be truly independent directors. The board must be effective and must meet periodically and it should also have long-term policy, strategy and Values.

3. To establish a Corporate Code of Ethics for themselves

Corporate ethics and values should be established at the top and should be used to govern the operations of the bank both from long-term and short-term point of view. These codes should be reviewed annually. Unless this exercise is accomplished, executive management cannot anticipate that the rank and file employees will follow such a code on their own.
4. **To consider establishing an office of the Chairman of the Board**

Such an office will be made to report to the board and will act as the board’s eyes and ears on a daily basis in connection with the functions of the bank.

5. **To conduct an effective and Operating Audit**

Committee, Compensation Committee and Nominating/Corporate Governance Committee

The audit committee, compensation committee and nominating committee should be composed of all independent, outside directors of the bank who operate independently. These committees should have access to attorneys and consultants paid for by the bank. This independence of committee will ensure against any bias in the internal audit committee’s decisions.

6. **To consider Effective Board Compensation**

Fair compensation should be paid to the directors. Their remuneration should be commensurate to with the risks they take.

7. **To disclose the information**

Bank will find that the disclosure will be quicker and more burdensome than it was in the past. This may be through quarterly letters to the shareholders or other types of communication.

8. **To establish Corporate Governance Procedures that will serve to enhance shareholder value**

The primary objective of the board of directors is to maximize the shareholders’ wealth. The strategy adopted to achieve this objective should now encompass corporate governance procedures and should be designed with long-term value for shareholders in focus.
Best corporate governance practices will enable banks to:

- Increase efficiency of their activities and minimize risks;
- Get an easier access to capital markets and decrease the cost of capital;
- Increase growth rate;
- Attract strategic investors;
- Improve the standards of lending;
- Protect the rights of minority shareholder and other counterparts;
- Strengthen their reputation and raise the level of investors and clients' trust.

Corporate Governance Principles for banks

The Basel Committee's revised principles on corporate governance at banks build on the Committee's 2010 document Principles for enhancing corporate governance. Specifically, the revised principles:

- strengthen the guidance on risk governance, including the risk management roles played by business units, risk management teams, and internal audit and control functions (the three lines of defense) and the importance of a sound risk culture to drive risk management within a bank;
- expand the guidance on the role of the board of directors in overseeing the implementation of effective risk management systems;
- emphasize the importance of the board's collective competence as well as the obligation on individual board members to dedicate sufficient time to their mandates and to remain current on developments in banking;
- provide guidance for bank supervisors in evaluating the processes used by banks to select board members and senior management; and
Recognize that compensation systems form a key component of the governance and incentive structure through which the board and senior management of a bank convey acceptable risk-taking behaviour and reinforce the bank's operating and risk culture.

**Conclusion**

Banking has become complex and it has been recognized that there is a need to attach more importance to qualitative standards such as internal controls and risk management, composition and role of the board and disclosure standards. Corporate Governance has become very important for banks to perform and remain in competition in the era of liberalization and globalization. The success of corporate governance rests on the awareness on the part of the banks of their own responsibilities. While law can control and regularize certain practices, the ultimate responsibility of being ethical and moral remains with the banks. It is this enlightenment that would bring banks closure to their goals.

Corporate governance has been proving a very efficient and effective system for our economy and to save the interest of shareholders but some more efficient monitoring and transparent internal audit system, efficient board and management can lead it to effective corporate governance.

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