Chapter II

Corporate Governance- A Prologue

2.1 Conceptual Framework of Corporate Governance

The term "Corporate Governance" is a versatile concept. “It includes the structure, systems and process a corporation uses to communicate authority, responsibility and accountability among stakeholders. Good Corporate Governance is one which balances the interests of various Stakeholders namely, a company's employees, government, suppliers, owners and customers to ensure the long-term sustainability and success of a corporate venture.”

Corporate Governance is based on standards and guidelines. The corporation while being independent identity, has network of relationships with a large body of stakeholders such as directors, staff, suppliers, customers, state, society and the community where corporation is located. Shareholders are the indispensable part of any organization, as they are capital providers to the organization. Directors become part of supervisory board to oversee the work of Executive committees. Here Corporate Governance play vital role for safeguarding the interest of various above mentioned Stakeholders.

Figure No. 2.1

![Figure 1: The Corporate Governance System](source: IFC, March 2004)
Laws and Regulations

One of the primary aspects of Corporate Governance is corporate compliance with all applicable Central and State regulations. Banks have to follow a set of laws administered by national and local governments. These laws shape the composition of a Bank’s Corporate Governance guidelines before it begins to operate.

Interests of Stakeholders

The stakeholders of a corporation are employees, customers, creditors, staff, suppliers, state, society and owners. Each of these parties is somehow related to the business. Corporate Governance Code helps the banks to meet the interests of each of these stakeholders without compromising the overall integrity.

Shareholders

“The owners of an organization are called shareholders. They are the primary stakeholders in any organization. The return on their investments in the corporation depends upon success of the corporation's workings. Shareholders meet annually to elect members of a Board of Directors who take care of their investments in the company. Shareholders may not play role in the company's operations or development. This “disconnect” between the owners of a corporation and the company itself is one of the most critical aspects of Corporate Governance. Good Corporate Governance emphasises on healthy and transparent relationship between stakeholders and company's operations.”

“2
Board of Directors

The Board of Directors in a corporation play imperative role in the Corporate Governance structure. Board members look after the budget and operations of a bank. It is part of their duty to scrutinize the operations and present them to the shareholders sincerely and accurately. The board is the primary player of Corporate Governance. They are the link between different stakeholders of the bank.

2.2 Objectives of Corporate Governance

“Effective Corporate Governance is indispensable, protects the rights of shareholders, includes operational risk management and holds directors accountable for their stewardship of the company.”³ The key objectives of Corporate Governance are listed below:

Transparency and Full Disclosure

Good Corporate Governance aims at ensuring a higher degree of transparency in a bank by emphasising on full disclosure of financial and non-financial data in the annual reports. Full disclosure includes compliance with regulations and disclosing important information to the shareholders. Directors on the Board should be independent so that the supervision of the bank management is unbiased. Transparency involves disclosure of all the information which leads to conflict of interest.

Accountability

Corporate Governance structure encourages accountability of the management to the company directors and the accountability of the directors to the shareholders. By keeping appropriate number of independent directors on the Board, a bank can aim to create good
Corporate Governance. Compensation Structure of the Bank has to be approved by the company directors to ensure its fairness and as per interests of the shareholders. Any kind of malfunctioning in the bank has to be closely taken care by the Board of Directors. The board also has a right to question vital decisions.

**Equitable Treatment of Shareholders**

One of the essential guidelines of Corporate Governance is equitable treatment of all the shareholders of the company. In some of the banks, a particular group of shareholders remains active due to their strong positions; such groups include high-net-worth individuals and organizations that have a significant proportion of their money invested in the bank. On the other hand, all shareholders deserve equitable treatment, and this equity has to be ensured by a good Corporate Governance code in any bank.

**Self Evaluation**

Corporate Governance expects the banks to evaluate themselves before they are scrutinized by regulatory bodies. Banks with a stronger Corporate Governance Code are better able to limit their contact to regulatory penalties and fines. A dynamic and self-regulated board can successfully point out the problems in the bank’s operations and help solve the issues within the banks premises.

**Increasing Shareholders' Wealth**

One of the chief objectives of Corporate Governance is to protect the long-term interests of the shareholders. Good Corporate Governance attracts the shareholders to invest in the company.
2.3 Relevance of Corporate Governance in Current Scenario

A company is the leading form of business organization. Number of stakeholders is related to a corporate body. “The company’s philosophy on Corporate Governance is to attain the highest level of transparency, accountability and integrity and also procedures and systems which are in accordance with best practices for governance. The exact meaning of Corporate Governance is to satisfy the aspirations of all stakeholders namely customers, suppliers, employees, shareholders and the society at large.”4 The Board chairs the broad principles of Corporate Governance focuses on its trusteeship role to align and direct the actions of the bank to achieve the objectives of transparency, responsibility and integrity.

“Corporate Governance concept emerged in India after the second half of 1996 due to liberalization and deregulation in the economy. In the changing scenario, there has been need for greater accountability of companies to their shareholders and customers. The report of Cadbury Committee on the financial aspects of Corporate Governance in the U.K. has given rise to the debate of Corporate Governance in India.”5

Need for Corporate Governance has been arising due to parting of management from the ownership. To become a successful firm it is required to concentrate on both financial and social aspect. It needs to be reasonable with suppliers, shareholders, customers etc. Organization has various responsibilities towards employees, customers, other stakeholders and it needs to serve its responsibilities at all aspects.

The “Corporate Governance concept” dwells in India from the Arthshastra time in the place of CEO at that time there were kings and
subjects. Today, corporate and shareholders replace them but the principles still exist i.e. excellent governance.

2.4 Historical Perspective of Corporate Governance

“The seeds of modern Corporate Governance were sown by the Watergate scandal in the United States. The universal movement for better Corporate Governance started from the mid-1980s and extended up to 1997. There were country-level initiatives such as the Cadbury Committee Report in the United Kingdom (1992), the recommendations of the National Association of Corporate Directors of the US (1995).”

The first major stimulus for Corporate Governance reforms came after the South-East and East Asian crisis of 1997-98. During this period healthy, rapidly growing, export-driven economies were going into financial crises. Slowly governments, institutions, banks as well as Corporates began to understand that the devil lay in the microeconomic details i.e. the transactions between companies, banks, financial organizations and capital markets; the design of laws related to Corporates, liquidation procedures and practices; the structure of ownership; sharp stock market practices; poor Boards of Directors; poor disclosures and transparency; and inadequate accounting and auditing standards.

Here Corporate Governance came out and moved to centre stage. Japan and Indonesia, countries in Asia recovered very fast. In the year 2001, Thailand, Malaysia and Korea were on the course to regain their historical growth rates. Due to such speedy recovery, Corporate Governance issues were in the danger of being relegated to the back
stage once again. It seemed that there is no urgency to impose concepts like enhanced accounting practices, better disclosure, and independent Board of Directors. Corporate Governance once again settled into a phase of extended inactivity.

In 2001, when global Corporate Governance movement was going into a bit of hibernation, disaster of Enron happened, followed by other scandals involving large US companies such as Qwest, Global Crossing and the exposure of lack of auditing that eventually led to the collapse of Andersen. These scandals stunned the foundations of the business world, and triggered more vigorous phase of reforms in Corporate Governance, accounting practices and disclosures and this time more systematically than ever before.

In June 2002 Enron filed for bankruptcy and the US Congress introduced Sarbanes-Oxley Bill. This piece of legislation called SOX brought with it fundamental changes in the area of Corporate Governance specifically for factors related to auditor independence, conflicts of interest, and corporate responsibility and enhanced financial disclosures. The SOX Act was introduced by the US President on 30 July 2002.

Although India has been fortunate in not having to go through the pains of enormous corporate failures like Enron and WorldCom, it has not been found wanting in its desire to further improve Corporate Governance standards. In the year 2002, the Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs appointed Naresh Chandra Committee to examine various Corporate Governance issues.
Although many enactments and initiatives were introduced in the field of Corporate Governance but in the year 2003, Narayana Murthy Committee gave recommendations specifically for the Indian Organizations.

Later on in the year 2005, J.J Irani Committee was constituted to make India globally competitive.

2.5 Driving Forces of Corporate Governance

“Good Corporate Governance is an expression of quality management to maintain checks and balances within the organisation, to increase transparency and preventing corporate abuse and misconduct. Good Corporate Governance also understands the importance of investors of long-term, persistent operating performance and tends to be inherently performance-driven.”7 The Corporate Governance scenario in India has been changing, particularly after enforcement of Sarbanes-Oxley act and is trying to improve the enforceability of creditors’ rights. Corporate Governance provides a mechanism which improves the efficiency, transparency, accountability of the corporate and builds the confidence of the stakeholders. There are number of factors responsible for the emergence of Corporate Governance in India, apart from unethical transactions and scams in the market environment. The major driving forces in the market that can be identified for the emergence of Corporate Governance in India are given below:

- Unethical business practices and security scams
- Globalisation
- Privatisation
- Knowledge and Trust of Institutional Investors
2.6 Popularly Espoused Principles of Corporate Governance

Main principles of Corporate Governance are: Right and Equitable treatment of Shareholders, Consistency, Responsibility, Accountability, Disclosure, Fairness, Transparency, Roles and Responsibilities of Board, Interest of Stakeholders Integrity, Ethical Behaviour Mechanisms and Control. Corporations influence mobilizing of their own resources, as well as resources of other stakeholders in the value chain. Therefore consistency of the policies creates the right hope in the value chain and helps the value chain to be stronger as a whole. Therefore, decision makers at all levels should assume the responsibility to take initiative and be answerable for their decisions. Each decision requires thought of the interests of different stakeholders. Those who are deemed to be fair in their decisions are able to establish longer term relationships which are critical for long term sustainable development. Trust can only be gained with transparency. Therefore, transparency and effective communication are critical for long term success. As each decision maker within the corporation has an important role in establishing the reputation of the corporation, deployment of these principles throughout the corporation is important for having successful Corporate Governance.

Privileges and unbiased treatment of shareholders

Corporations should respect the privileges and rights of the shareholders and help shareholders to exercise those rights. Organizations can facilitate shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.
Consistency, Responsibility and Accountability

People who make decisions in a corporation must be held accountable for their decisions and mechanisms. Investors hold individuals running the company accountable for their actions by carrying out usual inquiries to calculate the actions of the board. In a corporation, managerial responsibility means that the management be responsible for their behaviour and have means for punishing the negligence. It also means putting in place a system that puts the corporation on the right path when things go wrong.

Disclosure, Fairness and Transparency

Transparency is the measure of how easy it is for outsiders to find out and analyze a company's financial and non-financial fundamentals. The company must be fair and balanced and take into the account the interest of all of the company's stakeholders. Corporations should make all information available in appropriate and accurate press releases to give outsiders a true picture of what is happening within the corporation. Corporations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability.

Integrity and Ethical Behaviour

Ethical and responsible decision making is not only important for public relations, but it is also a essential element in risk management and avoiding lawsuits. Corporations should extend a code of conduct for their directors and executives that promotes ethical and responsible decision making. Many corporations set up Compliance and Ethics
Programs to curtail the risk that the firm steps outside of ethical and legal boundaries.

**Interests of other Stakeholders**
Corporations should recognize that they have legal and other obligations towards all legitimate stakeholders.

**Role and Responsibilities of the Board**
“The board needs variety of skills and understanding to deal with various business issues and the ability to review and challenge management performance. Board is required to have a suitable level of commitment to fulfil its responsibilities and duties. Corporate Governance standards give rise to issues like appropriate mix of executive and non-executive directors.”

**Mechanisms and Controls**
Corporate Governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and undesirable selection. For example, to monitor managers’ behaviour, an independent third party (the external auditor) attests the accuracy of information provided by management to investors.

**2.7 4 P’s Of Corporate Governance**
Corporate Governance is an incorporated framework whereby people formally organise themselves for a distinct purpose, and they apply crucial processes constantly to achieve predicted performance for Sustainable Development.
“The power of information is now in hands of PEOPLE. Now people can appraise corporate PERFORMANCE on hundreds of parameters. Power of information has also increased competition, which is now not limited to attracting customers, but it is more concentrated in attracting talent and financiers, without which corporations cannot work. Therefore it is critical that companies must have well defined PROCESS to consistently achieve predicted results every year. Corporate strategies and organizational practices are taken as given, and business ethics has become a competitive success factor. Good people associate with the Corporates which have a well defined PURPOSE in the form of vision and stakeholder policies and sincere efforts are put to fulfil those commitments in long run.”

Figure No. 2.2

Source: www.legc.com

In changing paradigm, 4Ps (People, Purpose, Process and Performance) have become critical for corporate sustainability.
2.8 Major Stakeholders in Corporate Governance

Figure. No. 2.3

“The most influential parties involved in Corporate Governance include government agencies, stock exchanges, management i.e. Board of Directors, CEO line management Officers, shareholders auditors, lenders, suppliers, employees, creditors, customers and the society at large.”\(^{10}\)

“A Board of Directors is expected to play a key role in Corporate Governance. The Board has the responsibility of framing the overall organizational strategies. The Board does not operate as a hierarchy. One of the most essential issues in Corporate Governance is the effectiveness and efficiency in the functioning of a corporate board. So it is necessary boards have in place, appropriate accountability mechanisms.”\(^{11}\)
All parties to Corporate Governance have an interest in the economic performance of the Organization. Directors, Employees and Management as a whole receive salaries, remuneration and Status and at the same time investors expect to receive financial returns. Lenders expect timely interest payments; Shareholders want optimum dividend distributions or capital gains on their stock. Customers are concerned quality goods and services; suppliers need compensation for their goods provided, and better trading relationships. These Stakeholders provide worth to the organization in various forms i.e. financial, physical, and human. These stakeholders are also apprehensive about corporate social performance.

An essential factor which decides the participation of the stakeholders in the organization is their confidence that organization will deliver expected outcomes. When the Stakeholders do not have enough confidence on the way organization is being controlled and directed, they are less likely to connect with the organization.

And when it becomes prevalent aspect, lack of confidence and participation arises among the stakeholders and these further results into political action. For competent working in accordance with Corporate Governance, Organizations need to understand differentiate between Board and Management.

The following table depicts conceptual difference between Board and Management.
There is thin line of difference between Board and Management. Board is responsible for overall accountability and supervision, whereas Management focuses on execution and implementation of the policies.

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<th>Management</th>
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<td>The mind</td>
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<td>Directors direct</td>
<td>Managers manage</td>
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<td>Policy</td>
<td>Action</td>
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<td>Corporate Governance</td>
<td>Corporate Management</td>
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(Source: AICD, 2003: 20)

- Management runs the business.
- The Board assumes that business is running in well mannered and right direction.
2.9 Committees of Corporate Governance

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<th>International Committees and Enactments</th>
<th>National Committees</th>
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<tr>
<td>• The Cadbury Committee (1992)</td>
<td>• CII (Confederation of Indian Industries) (1998)</td>
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<td>• The Greenbury Committee (1995)</td>
<td>• Kumar Mangalam Birla Committee (2000)</td>
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<td>• The Hampel Committee (1998)</td>
<td>• Naresh Chandra Committee (2002)</td>
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<td>• The Blue Ribbon Committee (1999)</td>
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<td>• The Sarbanes Oxley Act (2002)</td>
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**International Committees and Enactments**

**The Cadbury Committee (1992)**

The key highlighting of the Cadbury report has been the Board and Accounting aspects of Governance. “Major emphasises has been on need for fair and precise reporting of a company’s progress to the shareholders, which is board’s responsibility and subject to
confirmation by the auditors. Some recommendations of the Cadbury committee have been debatable. As per rules of this committee Corporates quoted on London Stock Exchange have been required to report annually to shareholders on their conformity with the code.”

The work of Cadbury Committee has laid down foundation for other committees. This process has proceeded in three directions: first, the further development of the codes of practice, second, exploration of wider governance issues and third, drive for better governance practices from enlightened company directors.

**The Greenbury Committee (1995)**

The Greenbury Committee was formed in the year 1994 by the Confederation of British Industry in response to growing concern at the level of salaries and bonuses being paid to senior executives.

Major Findings of this committee constitute recommendations regarding following points:

- Remuneration Committees made up of non-executive directors and should also determine compensation packages for whole team of Directors.
- Full disclosure and Shareholder’s approval for each executive's compensation package.
- Performance based Remuneration.
- Compensation Package set at a level that is necessary to attract, retain and motivate the top talent without being excessive.

This code of conduct has been voluntary in the hope that self-regulation would be sufficient to correct things.
The Hampel Committee (1998)

This Committee was shaped in the year November 1995 by the Financial Reporting Council, London Stock Exchange, Confederation of British Industry, and Institute of Directors to reconsider problems arising from the Cadbury and Greenbury Committees and evaluate implementation of their recommendations.

Ultimate Responsibility of Corporate Governance lies with the Boards of the Organization. Transparency has been more important than adhering to any particular set of guidelines, and any shareholders unhappy with the board's management have the option of using their votes accordingly.

The Combined code (1998)

The Combined Code of best practices and governance principles prescribed by the Committee are mostly a consolidation of the works of the Cadbury, Greenbury Committees as well as work of their own. They have retained the substance of the two earlier codes except in those few cases where committee has taken a different view from the predecessors.


The OECD Principles have been proposed to help the governments in evaluating and improving the legal and regulatory framework for Corporate Governance in their countries. The Committee also provides guidance and recommendations to stock exchanges, investors, Corporates, and other parties that have role in the process of developing good Corporate Governance. The OECD principles of good
Corporate Governance have suggested a majority of independent directors towards better Corporate Governance. The OECD Principles emphasize the importance, that the board should be able to exercise objective judgement on corporate affairs independently, in particular from management. Board independence is therefore generally accepted as requiring sufficient numbers of members who are not employed by the company and are not closely associated to the corporate and its management.

**The Blue Ribbon Committee (1999)**

This Committee has been set up at that point of time when many US companies resorted to improper and unlawful practices in financial reporting to their shareholders. The sponsors of the Committee felt an urgent need to strengthen the role of audit committees that results in more transparent and reliable financial reporting process. The Committee recommendations have been built on two factors: Firstly, an audit committee with actual practices and overall performance that reflects professionalism. Secondly, a legal framework that lay emphasis on transparency and accountability. The Blue Ribbon Committee in the USA has contributed remarkably in establishing the best concept of audit committees.

**The Sarbanes Oxley act (2002)**

“The Sarbanes-Oxley of 2002 has been result of a disastrous in the financial world, which included instances of unethical behaviour and fraudulent practices at major companies. The act has also revised Corporate Governance guidelines, new disclosure needs for the firms,
established that some frauds will be considered federal crimes and raised the criminal penalties for violating the securities laws.”

National Committees

CII (Confederation of Indian Industries)(1998)

Corporate Governance is related to Government, Regulators, Corporates, Boards, Markets, Employees, Investors and society on the whole as one of the most important business constituents given its all-pervasive characteristic. CII has been a leader in the evolution of Corporate Governance in India. CII also hosts the National Foundation for Corporate Governance, a Public Private Partnership initiative of the Ministry with the 3 professional institutes – the Institute of CA’s of India, Institute of CS’s of India, and the Institute of Cost Accountants of India. “CII encourages voluntary adoption of best practices and self-regulation by Corporates. CII’s broad and sustained policy support aims at facilitating the creation of a streamlined and harmonized regulatory environment.”

Kumar Mangalam Birla Committee (2000)

In early 1999, Securities and Exchange Board of India (SEBI) set up a committee under Shri Kumar Mangalam Birla, to encourage and raise the standards of Governance in the organizations. “The report submitted by the committee has been the first formal and comprehensive attempt to evolve a ‘Code of Corporate Governance’, in accordance to prevailing conditions of governance in Indian corporates, along with the conditions of capital markets.”

The Committee's suggestions have been to:
Recommend suitable amendments to the companies which are listed, to improve the standards of Corporate Governance, regarding disclosure of both financial and non-financial data, frequency of financial and non-financial disclosures, responsibilities of independent and executive directors;

- Code of Corporate Governance compulsory for every Organization.

The chief objective of the committee has been to view Corporate Governance from the perspective of the investors and shareholders and to prepare a ‘Guideline' to suit the Indian environment. The committee has recognized three essential elements of Corporate Governance i.e. the Shareholders, the Board of Directors and the Management and also it has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in the context of good Corporate Governance.

Naresh Chandra Committee (2002)

Naresh Chandra Committee has been established on 21 August 2002. The Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs appointed this Committee to examine various aspects of Corporate Governance. This Committee has been framed to analyse and recommend changes in diverse fields such as:

- Relationship between Statutory auditor and the Company;
- Alternation and Revision of statutory audit firms or partners;
- Appointment procedures for auditors and determination of audit fees;
• Autonomy of auditing functions;
• Measures ensuring management and companies fairness and transparency in financial affairs of companies;
• Randomized scrutiny of audited accounts;
• Ensuring the Independence and Effectiveness of Independent Directors.

**Narayana Murthy Committee (2003)**

There have been several Corporate Governance structures introduced, but there is no particular structure, which can be chosen as being better than the others. This committee’s recommendations are specifically designed for the Indian Organizations. Corporate Governance extends beyond corporate law. Its elementary objective is not mere fulfilment of the requirements of law rather it works for ensuring commitment of the Board in managing the company in a transparent manner for maximizing long-term shareholder value. Effectiveness of a system of Corporate Governance cannot be legislated by the law. In a changing environment, guidelines of Corporate Governance continuously need to be evolved. The Committee believes that its recommendations have raised the standards of Corporate Governance in Indian firms and make them attractive for domestic and global capital. These recommendations also form the base for further evolution of the structure of Corporate Governance in consonance with the rapidly changing economic and industrial environment of the country in the new millennium.

**J.J Irani Committee (2005)**

The Government of India constituted an expert committee on Company Law on 2 December 2004 under the chairmanship of Dr J. J. Irani. The
effort has been made to make India globally competitive for attracting foreign exchange, by suggesting systems in the Indian corporate environment which are transparent, simple and globally acceptable. One of the important recommendations of the J. J. Irani Committee has been that one-third of the board of a listed company should comprise independent directors.

2.10 Evaluation of Governance Structure

“For the purpose of analysing governance structures, processes in the organizations, credit rating agencies have been continuously working. Two essential entities that have been performing the task of evaluation are:

- CRISIL
- ICRA

CRISIL addresses the issue of Corporate Governance by providing an independent assessment of an entity’s performance and future expectations on balanced value creation through sound Corporate Governance practices.”

Good corporate governance is mirror of fair, transparent, and responsible interactions among the organizations management and various stakeholders. CRISIL GVC (Governance and Value Creation) Ratings consider Corporate Governance practices in an organization with respect to their impact on all stakeholders who relate to the firm, such as employees, suppliers, shareholders, lenders, and society. CRISIL evaluates two broad aspects to arrive at GVC rating for an organization.
• Value Creation and Distribution

• Corporate Governance along with Wealth Management

**ICRA** addresses the issue of Corporate Governance by indicating the level to which an entity accepts and follows the codes and guidelines of Corporate Governance practices. ICRA’s Corporate Governance Rating (CGR) seeks to evaluate a company’s business conduct and practices and the quality of its disclosure standards in terms of fairness and transparency from the perspective of its financial stakeholders.

### 2.11 Key Parameters of Corporate Governance

“Corporate governance relates to the quality, transparency, and reliability of the relationships between the stakeholders and accountability of each stakeholder in delivering sustainable value to the organization.”

Foundation of Corporate Governance lies on key parameters that help to judge the organization’s governance pattern. These parameters are the criteria for evaluating standards of Corporate Governance in the banks as well. Some essential parameters are listed below:

- Statement of Company’s philosophy on Corporate Governance
- Structure and strength of the Board
  - Board Composition
  - Board Size
• Disclosures

  ➢ Financial Disclosures
  ➢ Non-Financial Disclosures

• Board Committees

  ➢ Audit Committee
  ➢ Remuneration /Compensation Committee
  ➢ Shareholders/Investors Grievance Committee
  ➢ Health and Environment Committee
  ➢ IT Strategy Committee
  ➢ Nomination Committee
  ➢ Ethics and Compliance Committee
  ➢ Whistle Blowing Committee
  ➢ Risk Monitoring Committee

• Means of communication

The above mentioned factors have to be taken care of while complying with the code of Corporate Governance. These parameters are used for assessing quality and effectiveness of Corporate Governance in the banking sector.

2.12 Introduction to Indian Banking Industry

The financial activities in the early period were handled by money lenders and individuals. At that time the interest rates were very high. There was no security of public savings and no uniformity in loans.
Fully organized Banking sector regulated by the government was established to overcome above mentioned problems. The structured banking sector has been working within the financial system to grant loans, keep deposits and provide enhanced services to the customers. The following functions of the bank explain the need of the bank and its importance:

- To grant the security to the savings of customers.
- To organize the supply of money and credit in the economy.
- To encourage public confidence in the working of the financial system, increase savings speedily and efficiently.
- To avoid focus of financial powers in the hands of a few individuals and organizations.
- To set equal norms for all types of customers.

Existence of an efficient banking system is vital for achieving economic growth as banks are the mechanisms that channelize the savings to investments. Banking sector has capacity to encourage economic growth as it allocates savings to those avenues which yields higher returns.

India's banking system is a robust one as it includes 86 scheduled commercial banks, 82 regional rural banks, 1,645 urban cooperative banks and 95,765 rural cooperative banks, and has proved its determination by standing unaffected during the recent global financial chaos.
India has a healthy economy because of sound and effective banking system. The banking system is hassle free and able to meet the new challenges posed by technology and both internal and external factors.

In the past three decades, India's banking system has earned several outstanding achievements to its credit. The most remarkable is its extensive reach. It is no longer confined to cities; it has reached even to the remote corners of the country. Banking today has become convenient and instant as the account holder does not have to wait for hours at the bank counter for getting a draft or for withdrawing money from his account.

History of Banking in India

“The first bank in India was established in 1786. The whole Journey of Indian Banking System can be segregated into three distinct phases:

- Early phase of Indian banks, from 1786 to 1969
- Nationalization of banks, from 1969 to 1991
- New phase of Indian banking system”

Phase 1

The first bank in India was set up in the year 1786 i.e. General Bank of India, followed by Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal in the year 1809 Bank of Bombay in the year 1840, and Bank of Madras in the year 1843 as independent units and called them Presidency banks. Imperial Bank of
India was established in the year 1920 by amalgamating all three banks. Allahabad Bank was established in 1865. Punjab National Bank was set up in the year 1894 and its headquarters were set up in Lahore. During the period 1906 and 1913, Bank of Baroda Bank of India, Central Bank of India, Canara Bank, Indian Bank, and Mysore Bank were set up. The Reserve Bank of India came into existence in the year 1935.

Between the period 1913 and 1948, the growth of the banking sector slowed down and banks also experienced periodic failures. To restructure the functioning and activities of all the banks, the Government of India started with the Banking Companies Act, 1949, which was replaced by Banking Regulation Act, 1949 as per amending Act of 1965. In this phase Reserve Bank of India (RBI) was given extensive powers for the supervision of banking in India as the fundamental banking authority. During those days, the general public had lesser confidence in banks.

**Phase 2**

Major initiatives were taken by the Government for banking sector after Independence. In the year 1955, the Imperial Bank of India became nationalized and started offering extensive banking services in rural and semi-urban areas. The government constituted the State Bank of India to act as the principal agent of the RBI and to handle banking transactions of the Union government and state governments all over the country. Seven banks owned by the Princely states were nationalized in 1959 and they became subsidiaries of the State Bank of India. In the year 1969, 14 commercial banks in the country were nationalized. In the second phase in the year 1980, seven more banks
were nationalized. 80 percent of the banking sector in India came under the government ownership.

## Phase 3

This phase has introduced many products and facilities in the banking sector as part of the reforms process. In the year 1991, under the chairmanship of M Narasimham, a committee was set up, which worked for banking sector liberalization. And that resulted into entrance of foreign banks. Overall Banking Industry of our country is outperforming. Efforts are being put to give a satisfactory service to customers. E-banking services like net banking, phone banking have been introduced. The entire system became more opportune and speedy.

### 2.13 Corporate Governance in Indian Banking Industry

Reserve Bank of India has taken various steps furthering Corporate Governance in the Indian Banking System. These can be classified into the following three categories:

a) Transparency and Disclosures
b) Off-site inspection
c) Prompt corrective action

Transparency and disclosure standards are important constituents of a sound Corporate Governance mechanism. Transparency and accounting standards in India has been enhanced to align with international best practices. Still there are many gaps in the disclosures in India in comparison with the international standards. Hence, the disclosure standards need to be improved. The off-site inspection mechanism also helps in monitoring
the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI also brings out the periodic data on “Peer Group Comparison” on critical ratios to maintain peer pressure for better performance and governance. Prompt corrective action has been adopted by RBI as a part of core principles for effective banking supervision.

Reserve Bank in India is concentrating on two points namely Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability. These points enable the intervention of RBI through a set of mandatory actions to stop further deterioration in the health of banks showing signs of weakness.

Banks are different from other Corporates in important respects, and that is the reason Corporate Governance of banks is not only different but also more critical. As Banks are lubricant to the wheels of the economy. By the very nature of their business, banks are highly leveraged. They accept large amounts of uncollateralized public funds as deposits in a fiduciary capacity and further use those funds for credit creation. The presence of large base of depositors in the stakeholders group sets banks apart from other Corporates. If a corporate fails, the consequences can be restricted to the stakeholders. But if a bank fails, the impact can spread rapidly through to other banks leading to serious consequences for the entire financial system and the macro economy. If banks are given importance in our economy in so many ways it has to be followed by giving importance to Corporate Governance too. Boards and senior managements of banks have to be sensitive to the interests of the depositors, be aware of the potentially destructive consequences of excessive risk taking, be alert to warning signals and be wise enough to contain irrational enthusiasm.
Corporate Governance is a multi-dimensional term. Good Corporate Governance safeguards the interest of all the stakeholders related to an organization. Board of Directors play significant role in aligning organizational practices with code of conduct defined for Corporate Governance. High quality Corporate Governance Practices lead to better accountability, transparency, fairness and integrity within the organization. It helps in building shareholder’s trust and enhancing their wealth. Concept of Corporate Governance picked up after enforcement of Sarbanes-Oxley act.

Corporate Governance is a structure based on 4 P’s. Corporate Governance is an incorporated framework whereby people formally organise themselves for a distinct purpose, and they apply essential processes constantly to achieve predicted performance for Sustainable Development.

Various enactments and committees have been constituted to keep check on organization’s working. Regulatory and Government bodies have been heading these committees to standardize Corporate Governance code in the organizations.

Key parameters have been identified which have to be included as essential part in annual reports of the banks. These parameters check the compliance of code of Corporate Governance in the banks.

CRISIL and ICRA are the entities evaluating the governance patterns in the organizations. Corporate Governance principles are best applicable to banking industry in India as the banking organizations are supposed to be trustees of public assets.
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