CHAPTER 4
CORPORATE GOVERNANCE

4.1 Introduction:

The word corporate when mentioned in the phrase ‘corporate governance’ refers to a large company or organization. The word Governance in the phrase indicates the role of people who are trusted with the duty of determining the strategic decisions of a company or a state. It indicates and requires authority being granted to those persons so that they can control, direct or supervise the entire company. This authority is misused by most ‘directors’ usually for their own interest and hence it is necessary to have corporate governance regulations and codes of best practice.

“Corporate governance being the process method and the structure used to manage and direct the business affairs of an institution with the goal of ensuring its safety and soundness and enhancing shareholder value.”-Bank of Zambia (2006). Corporate governance is the mechanism by which an entity (or company) is directed and controlled. Good governance is that which is accountable and is transparent. It is responsive and equitable. It is inclusive and effective as well as efficient. It is participatory and consensus oriented and follows the rule of law. 100

The 1992 Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) describes corporate governance as the system by which companies are directed and controlled.

A corporate governance system should have the main aim of establishing the principles of fairness, transparency, objectivity, decency, responsibility, accountability, status, judgment and integrity among those responsible for the governance of companies.

“Good corporate governance is about intellectual honesty and not sticking to rules and regulations”101

100 Shri Anand Sinha, 2013, “Governance in Banks and Financial Institutions” Address of, Deputy Governor, Reserve Bank of India, delivered on his behalf, at the L & T Management Development Centre, Lonavla on March 19, 2013.

Corporate governance has been a subject of public interest only since about 1980's. The reason is the occurrences of frauds of various kinds taking place in India as well as in other countries. Due to an almost breakdown of the corporate ethical values and the collapse of the spirit of governance, shareholders were unable to safeguard their interests in the companies. They searched for safety of their investments made in the Indian capital market. There are a number of corporate failures, prominent among them the BCCI (Bank of Credit and Commerce International), and the Robert Maxwell Mirror groups' News International. The steps to prevent failure of business and creating a spread of financial scams, commenced began with the London Stock Exchange establishing the Cadbury Committee in May, 1991 under the chairmanship of Sir Adrian Cadbury. The Committee drafted the code of the best practices to be followed in the UK. The Committee report came out in December, 1992, after which some more efforts were made in the UK in this regard and, ultimately, the Turnbull Guidelines came out in September, 1999. These developments occurring in the UK with regard to corporate governance made a strong impression in India. The Confederation of Indian Industries (CII) had appointed a National Task Force under the guidance of Rahul Bajaj. The Task Force submitted its report/ code entitled "Desirable Corporate Governance in India in April, 1998." It contained seventeen recommendations. Following this, the Security and Exchange Board of India (SEBI) appointed a committee under Kumara Mangalam Birla as the chairperson. The committee submitted its report in May 1999. It had nineteen mandatory and sixteen non-mandatory recommendations. In implementing the recommendations, SEBI had asked the Stock Exchange to include a new clause number 49 in the Listing Agreements. Many other committees were also constituted dealing with the subject as follows:

In April, 2002, The Ganguly Committee was constituted for effecting improvements in governance in banks and financial institutions.

Union Ministry of Finance formed a committee headed by Naresh Chandra to deal with governance and corporate audit, and in December, 2003 committee submitted its report.
In February, 2003, SEBI appointed a committee on corporate governance which was headed by N.R. Narayana Murty,. SEBI had amended its clause 19 in the Listing Agreement and it became applicable in early 2006.

In December 2004, the Government of India appointed an expert committee headed by the chairmanship of Dr. J.J. Irani. In sight of the Government's intentions, it was predictable that the J.J. Irani report/recommendations will be included in the Act. Report of the committee was made accessible in May, 2005. In May, 2006, the Union Government gave consent to the Amendment Bill, 2006.

4.2 Concept of Corporate Governance
The idea of corporate governance was the effect of extensive efforts focused on maximizing the wealth of the share owners, some definitions of corporate governance are given here:

“According to the Cadbury Committee, corporate governance is a system through which firms/companies are controlled/directed.

Y.C. Deveshwar, Chairman of India Tobacco Company, has given a definition that covers the systems, structure as well as the methods/processes in a corporate body, which are taken as the most pertinent factors for improving the wealth generation capacity of the outfit.

James D. Wolfensohn, President World Bank has defined that corporate governance promotes fairness, accountability, and transparency in the corporate body.

4.3 Purpose of Corporate Governance

“Corporate governance is necessary for of a company's survival as also growth.

The main purposes of corporate governance can be summed up as:

- Encouraging excellence and effectiveness in the service of the nation.
- Encouraging effectiveness/efficiency in the capital market.
- Promoting trust among the equity holders about the firms' capabilities as well as healthy work ambience on a long-term basis.
- Promoting development of the business.
• Improving the Board members' control over the affairs of the corporate body.

4.4 Basic Principles of Corporate Governance

The following are the basic principles of corporate governance:

1. Transparency is the most significant principle which requiring the transparent companies policies and actions to be fair, equitable to all stakeholders, aiming at disclosure of facts and safeguarding shareholders' values.

2. Accountability is another significant principle implying that the Board is accountable to the shareowners/equity owners and the firm’s management is accountable to the shareowners and the directors of the Board. Accountability with the firms' performance improves and it promotes trust in the firms' activities.

3. The principle of trusteeship means that the Board is obliged to protect and enhance interests of the shareowners/stakeholders.

4. Fairness among the Board.

5. A system of checks and balances has to exist to prevent any misuse of power by timely and corrective action.

6. Wise and external audit to work independently and for deeper investigation.

7. Existence of regulatory regime to oversee the effective working of the systemic activities.

8. Empowering the managers/executives by creation of an ambience of creativity and innovation through policy changes.

9. Encourage and reward the whistle-blowers through policy changes, as recommended in the Narayana Committee report.²

4.5 Model of Corporate Governance

4.5.1 The Anglo-American Model of Corporate Governance

Figure No. 4.1 The Anglo-American Model of Corporate Governance

![Diagram of the Anglo-American Model of Corporate Governance](image)

(Source, Sheeba Kapil, Financial management, Pearson publication, 2014, pp640)

“Corporate governance initiatives are a platform where the stakeholders of a firm interact with each other for the attainment of their objectives. The Anglo-American model (see Figure 4.1) of corporate governance; the company is managed by managers who are professionals. The management must report the critical-strategic decisions taken by them to the board and shareholders of the firm. The board of directors should be knowledgeable, informed and active participants of the firm’s initiatives. They should be motivated to review the management ventures and critically evaluate the firm’s policies and practices.

Here, the corporate governance can be viewed from shareholders’ perspective. The firm focuses more on the shareholder’s interest. The interest and rights of shareholders are considered primarily over those of management and creditors. The management does not own any claim in the ownership. The management and ownership are completely different. However, the ownership is distributed evenly amongst institutional holders and individuals (the institutional investor may together hold more than 50 per cent of shares, but individually they do not hold more than 10 per cent). If the owners of the company are satisfied, they hold this company’s shares, but if they are dissatisfied, they sell off their shares in market. An increasing number of institutional investors understand the urgent need of corporate governance practices. They believe in continuous
monitoring of their investment. In this model, the disclosure norms of companies are detailed and vast and strict norms for insider trading prohibition and penalties for price manipulations are suggested. There are adequate measures for the protection of investors especially small investors. Thus in the Anglo American model of corporate governance, there is active and key role played by the CEO, capital market, creditors and short-term investors.\(^{103}\)

### 4.5.2 The German and Japanese Model

The Japanese model (see Figure 4.1) talks about the appointment of a large number of boards of directors by shareholders. The number is as large as 50 when compared to 12 in the Anglo-American model.

**Figure No.4.2 The Japanese model of corporate governance\(^{104}\)**

![Diagram of the Japanese model of corporate governance]

The model states that Shareholders must appoint more representatives in board of directors during distress times or during weak financial performance period. There is active participation in the equity of companies, by the banks and financial institutions. Here, the main focus is on all the stakeholders that comprise of the shareholders, employees, management, government, customers, creditors (banks), suppliers, etc. The corporate governance under this model can be viewed from stakeholders’ perspective. The corporate

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governance practices focus stakeholders’ and management’s interest along with shareholders’ interest. The relationship between the management and the shareholders is close and steady. These firms own each other’s shares and bonds, that is, they are stakeholders in the keiretsu firms. They give each other more preference in business transactions over other firms not a part of keiretsu. Each keiretsu is formed along with a big bank. The stock ownership is concentrated or proxy-controlled by banks. There exists direct involvement of banks in the operations of the firm. They participate in the day-to-day monitoring and decision-making of the firm. The creditors’ claims are well protected by legal clauses.

**Figure 4.3: The German corporate governance model**

(Sheeba Kapil, Financial management, Pearson publication, 2014, pp641)

“However, the disclosure norms for companies under this model are not very strict, and there are relaxed rules for insider trading and price manipulations. There are limited accounting requirements. This has impaired the efficiency of capital market in these countries. Thus, in the German-Japanese model (see Figures 3.5.2 and 3.5.3), there is active participation by banks and long-term investors. The difference in this model exists because the market for corporate control is highly different across countries. The market for corporate control is more active in the USA and the United Kingdom when compared to Europe or
Japan. Hence, monitoring by banks plays a larger role in European countries or Japan than in Western countries.”

4.6 Sarbanes-Oxley Act, 2002

Sarbanes-Oxley Act was passed in July, 2002 as a Law for controlling corporate governance and excessive accounting malpractices in the US and other countries which had secondary listings in the country.

Sarbanes-Oxley Act, 2002 presents the following provisions:

- Penalty for corporate fraud. It includes up to twenty years imprisonment for altering/destroying documents which are subject to federal inquiries.
- CEOs are liable to ten to twenty years of imprisonment with fines one to five million US dollars if they certify false accounts.
- Time period for engaging in law suits by defrauded investors was enhanced.
- Accounting firms are prohibited from providing consultancy and any non-auditing service to their client organization.
- New rules to be framed for financial analysts by the Security and Exchange Commission in order to highlight conflict in interest, in particular, in investment banking system.
- Accounting profession to be under strict scrutiny by a five-member private sector board which will have disciplinary as well as court/subpoena powers.

4.7 The Cadbury Report

The British approach to business is oriented to trusting the people until proved otherwise. People of high eminence, probably led by Sir Adrian Cadbury, Chairman of Bank of England, were requested by the London Stock Exchange to study the financial aspects of the subject ‘corporate governance’. This resulted in the 1992 report of the Cadbury Committee on the financial aspects of corporate governance. The report established the UK's position as a leader on the subject. It also brought about a general movement on corporate governance. The movement was activated on two fundamental objectives:

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First, to achieve more rigorous/stringent accountability of the members of a board of directors as well as the directors to their owners for their own activities. Second, to counter attack on the rising corruption in enterprises—both PSUs and private sector enterprises. Hence, the aim was to strengthen the movement to bring the rule of law, autonomy laundering bills as well as anti-terrorism practices. All this aimed at re-enforcing the democratic methods for achieving, in the penultimate, objective of a global civil society. Many governments and corporate are working sincerely, through development of self-regulatory codes of best practices and through reporting system (annual), to keep the owners informed about the operations/accounts.

Cadbury report has done a remarkable job by dividing the role of the CEO from the role of the Chairman and has strengthened the role of the audit committee. As per the report, only independent directors will sit in the committee and they could have access to external legal advice at the cost of the companies. It also underlined the importance of competence and the roles of the secretary to the board and the CEO. Cadbury's report has highlighted the supremacy of the board, its final power, integrity and accountability.

The crisis in corporate governance in Western economies is attributed to the lack of understanding on the part of business executives, politicians and the public, of the roles, responsibilities and tasks of the directors on the board of a corporation. This has resulted in loss of public confidence in the market and undermined the driving forces of the equity market. This has lead to the end of an important era in the history of capitalism. This makes it necessary to create a system of selection, training and development also a system to appraise the directors and instilling the values and self-regulation. In July, 2002, George Bush II in his address had highlighted the need to amend the law so that corporations could begin a new era of integrity. He concentrated on the need to protect the interest of the shareholders by means of nurturing talents for raising their competencies for safeguarding their interest. The Cadbury report in the UK divided the role of CEO from that of the Chairman and strengthened the role of the audit committee. The report brought a general progress on corporate governance for achieving strict accountability of the board members.

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and the directors for their owners. The board of directors wants to ensure the board performance, through four activities, namely, envisioning, thinking strategically, supervising, managing and accountability.

In totality, the supremacy of the board of directors, its ultimate power, integrity and accountability were underlined. At this time, UK has seen a transition in its approach from being more oriented to board conformance to performance by the board.

There are three barriers to performance of the board, namely, over-regulation of the board due to multiplicity of civil and criminal laws and the ideal non-legislative concept of 'self-regulation'. A board needs to ensure the directorial balance between board performance and board conformance, through four tasks, namely envisioning, thinking strategically, supervising, managing and accountability.  

4.8 Overview of bank corporate governance

“Effective corporate governance practices are necessary for achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole. Poor corporate governance can lead to bank failures, which in turn can pose significant public losses and consequences due to their potential impact on any applicable deposit insurance system and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. Poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a bank run or liquidity crisis. The legal and regulatory system in a country determines the formal responsibilities a bank has to its shareholders, depositors and other relevant stakeholders. Banking industry states that corporate governance involves the allocation of authority and responsibilities, so that its board and senior management govern the business and affairs of a bank. Corporate governance set the bank’s strategy and objectives, decides the bank’s risk tolerance/appetite to operate the bank’s business on a day-to-day basis. Protect the interests of depositors,

meet shareholder obligations, and take into account the interests of other recognized stakeholders; and align corporate activities and behavior with the expectation that the bank will operate in a safe manner, with integrity and in compliance with applicable laws and regulations.

Supervisors have a keen interest in strong corporate governance as it is an essential element in the safe and sound functioning of a bank and can adversely affect the bank’s risk profile if not implemented effectively. Well-governed banks contribute to the maintenance of an efficient and cost-effective supervisory system. Sound corporate governance also contributes to the protection of depositors and may permit the supervisor to place more reliance on the bank’s internal processes. Moreover, sound corporate governance practices can be helpful where a bank is experiencing problems. In such cases, the supervisor may require substantially more involvement by the bank’s board or those responsible for the control functions in seeking solutions and overseeing the implementation of corrective actions.

There are unique corporate governance challenges posed where bank ownership structures are unduly complex, lack transparency, or hamper appropriate checks and balances. Challenges arise when insiders or controlling shareholders exercise undue influences on the bank’s activities. The Committee has not suggested that the existence of controlling shareholders is in and of itself inappropriate. Indeed, controlling shareholders can also be beneficial resources for a bank. Nevertheless it is important that supervisors take steps to ensure that such ownership structures do not abstruct sound corporate governance. In particular, supervisors should have the capacity to assess the fitness and propriety of significant bank owners as well as board members and senior managers.

Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability. Such factors, however, are often outside the scope of banking supervision.13 Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound
corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so. “

4.9 Corporate Governance in India – a background

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world’s poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures. In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies.

The 1956 Companies Act as well as other laws governing the functioning of joint-stock companies and protecting the investors’ rights are built on this foundation.

The beginning of corporate developments in India were marked by the managing agency system that contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence was marked by the 1951 Industries (Development and Regulation) Act as well as the 1956 Industrial Policy Resolution put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector.

The situation grew from bad to worse in the following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and complicated emolument structures to beat the system. In the absence of a developed stock market, the three all-India development finance institutions (DFIs) – the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment

\[108 \text{http://www.bis.org/publ/bcbs294.htm} \]
Corporation of India – together with the state financial corporation’s became the main providers of long-term credit to companies. Along with the government owned mutual fund, the Unit Trust of India, they also held large blocks of shares in the companies they lent to and invariably had representations in their boards. In this respect, the corporate governance system resembled the bank-based German model where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality of their lending and thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. With their support, promoters of businesses in India could actually enjoy managerial control with very little equity investment of their made by them. This stage would come after the company has defaulted on its loan obligations for a while, but this would be the stage where India’s bankruptcy reorganization system driven by the 1985 Sick Industrial Companies Act (SICA) would consider it “sick” and refer it to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the BIFR it wins immediate protection from the creditors’ claims for at least four years. Between 1987 and 1992 BIFR took well over two years on an average to reach a decision, after which period the delay has roughly doubled. Very few companies have emerged successfully from the BIFR and even for those that needed to be liquidated, the legal process takes over 10 years on average, by which time the assets of the company are practically worthless. Protection of creditors’ rights exists only on paper in India. Given this situation, it is not at all surprising that banks, flush with depositors’ funds routinely decide to lend only to blue chip companies and park their funds in government securities. Financial disclosure norms in India are traditionally superior to most Asian countries but fall short of those in the USA and other advanced countries. Noncompliance with disclosure norms and even the failure of auditor’s reports to conform to the law attract nominal fines with hardly any punitive action. The Institute of Chartered Accountants in India has not been known to take action against erring auditors. As the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and
registrations intentional or unintentional. Sometimes non-voting preferential shares have been used by promoters to channel funds and deprive minority shareholders of their dues.

For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing requirements of exchanges enforced some transparency, but non-compliance was neither rare nor acted upon. All in all therefore, minority shareholders and creditors in India remained effectively unprotected in spite of a plethora of laws in the books.\(^{109}\)

### 4.9.1 Changes since liberalization:

The years since liberalization have seen wide ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country. Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 90’s – the Harshad Mehta stock market scam of 1992 followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices as well as those of companies simply disappearing with investors’ money. These concerns about corporate governance stemming from the corporate scandals as well as opening up to the forces of competition and globalization gave rise to several investigations into the ways to fix the corporate governance situation in India. One of the first among such endeavors was the CII Code for Desirable Corporate Governance developed by a committee chaired by Rahul Bajaj. The committee was formed in 1996 and submitted its code in April 1998. Later SEBI constituted two

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committees to look into the issue of corporate governance – the first chaired by Kumar Mangalam Birla that submitted its report in early 2000 and the second by Narayana Murthy three years later.

SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 of the Listing Agreements. They were applied to companies in the Bombay Stock Exchange and S&P C&X Nifty indices, and all newly listed companies, on March 31, 2001; to companies with a paid up capital of Rs. 10 crore or with a net worth of Rs. 25 crore at any time in the past five years, as of March 31, 2002; to other listed companies with a paid up capital of over Rs. 3 crore on March 31, 2003. The Narayana Murthy committee worked on further refining the rules.

4.10 Corporate Governance of Banks
Proper corporate governance is must for banks and financial institutions. As banks play an important role in the financial and economic system of a developing country, bank failure because of unethical or incompetent management action poses a threat to both the shareholders and as well as depositors and the nation’s economy also. Two main features set banks aside from other business i.e. the level of transparency in their working and the comparatively greater role of government and regulatory agencies in their activities. The very nature of the banking business makes it extremely easy and tempting for management to alter the risk profile of banks as well as siphon off funds. It is, therefore, much more difficult for the owners to effectively monitor the functioning of bank management. Existence of explicit or implicit deposit insurance also reduces the interest of depositors in monitoring bank management activities.

It is partly for these reasons that wise norms of banking and close monitoring by the central bank of commercial bank activities are essential for smooth functioning of the banking sector. Government control or monitoring of banks, on the other hand, brings in its wake, the possibility of corruption and diversion of credit for political purposes which may, in the long run, jeopardize the financial health of the bank as well as the economy itself. The reforms have marked a shift from hands-on government control interference to market forces as the dominant example of corporate
governance in Indian banks. Competition has been encouraged with the issue of licenses to new private banks and more power and flexibility have been granted to the bank management both in directing credit as well as in setting prices. The RBI has moved to a model of governance by wise norms rather than from direct interference, even allowing debate about appropriateness of specific regulations of banks. Along with these changes, market institutions have been strengthened by the government to infuse greater transparency and liquidity in markets for government securities and other asset markets.

This market orientation of governance disciplining banking has been accompanied by a stronger disclosure norms and stress on periodic RBI checking.

From 1994, the Board for Financial Supervision (BFS) inspects and monitors banks using the “CAMELS” (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. Audit committees in banks have been stipulated since 1995.

Greater independence of public sector banks has also been a key feature of the reforms. Nominee directors – from government as well as RBIs – are being gradually phased off with a stress on Boards being more often elected than “appointed from above”. There is increasing emphasis on greater professional representation on bank boards with the expectation that the boards will have the authority and competence to properly manage the banks within the broad prudential norms set by RBI. Rules like no lending to companies who have one or more of a bank’s directors on their boards are being softened or removed altogether, thus allowing for “related party” transactions for banks.

The need for professional advice in the election of executive directors is increasingly realized.

As for old private banks, concentrated ownership remains a widespread characteristic, thus limiting the possibilities of professional excellence and opening the possibility of misdirecting credit. Corporate governance in co-operative banks and NBFCs perhaps need the greatest attention from regulators. Rural co-operative banks are frequently run by politically powerful families as their personal fiefdoms with little professional involvement and considerable channeling of credit to family businesses. It is generally believed that the “new” private banks have better and more professional corporate
governance systems in place. However, the recent collapse of the Global Trust Bank has seriously challenged that view and spurred serious thinking on the topic.

With the recent increase in corporate scandals and the subsequent interest in corporate governance, a number of corporate governance norms and standards have arisen around the globe. The Sarbanes-Oxley legislation in the USA, the Cadbury Committee recommendations for European companies and the OECD principles of corporate governance are perhaps the best known among these.

The problem for private companies, that form a vast majority of Indian corporate entities, remains largely unaddressed. The agency problem is likely to be less marked there as ownership and control are generally not separated. Exploitation of minority shareholder though, can very well be an important issue in many cases.

Creation of norms and guidelines are an important first step in a serious effort to improve corporate governance. The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. More and more it appears that outside agencies like analysts and stock markets have the most influence on the actions of managers in the leading companies of the country. But their influence is restricted to the few top companies. More needs to be done to ensure adequate corporate governance in the average Indian company.

Even the most prudent norms can be ignored in a system plagued with widespread corruption. Nevertheless, with industry organizations and chambers of commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past.

4.10.1 Corporate governance in Indian banks

In the content of corporate governance, the Indian banking sector has a special role to play, not only because of the critical nature of the business but because it is the sector that has had large public ownership- which is one in the process of being divested historically, banks have been used for government policy
implementation. The differences and criticalities of the sector arise out of the following factors:

A) In the case of banks and financial intermediaries, interests of other stakeholders, namely the depositors, appear to be more important as compared to other corporate.

B) The risk in banking institutions is many (for example credit risk, counterparty risk, liquidity risk etc) and these have systematic implication.

Corporate governance in general is a systematic process for enhancing wealth generating capacity, meeting stakeholders and social expectations. In this context, governance in banks and financial institutions (FI’s) has been attracting special attention in India during the past few years for a number of reasons. The unstable and opaque banking and financial system can severely disrupt macro economic performance of that country. It is therefore necessary to strengthen both supervisory and regulatory framework of the banking and financial system. Further, with increasing deregulation, inspite of the fact that the banking and financial system all over the globe including India, are required to meet certain international benchmarks or standards as per regulation, particularly in the areas of supervision, accounting and disclosures. However, the issues are complex and merely meeting these standards would not be sufficient by themselves for stability in the long run unless there are well established governance processes permeating throughout an organization through a system proper conduct and professional management. Banking institutions must have a satisfactorily level of corporate governance related to its size and nature of its business and activities

1) Banks have an overwhelmingly dominant position in economies financial system and are extremely important engines of economic growth.

2) As financial markets usually are underdeveloped banks in such economies are typically the most important source of finance for the majority of firms.

3) In addition to providing a generally accepted means of payment, banks in such countries are usually the main depository of economy’s savings.

4) Many developing economies have recently liberalized their banking system through privatization or disinvestment and reduced the role of
economic regulation, consequently managers of banks in these economies have obtained greater freedom in how they run their banks.\textsuperscript{110}

4.10.2 Need for good corporate governance in the banking sector

Good corporate governance is important for all types of business but, specifically for banks, mutual funds and financial institutions. The reasons for strict adoption of corporate governance by banks are as follows:

“Crucial role: Banks are the mobilizers and dispensers of funds. They discharge the crucial role of being an intermediary between those possessed of surplus funds and those who need these funds. A healthy and stable banking system is necessary for the health of the economy. The world over financial crisis has been precipitated due to bungling in the banking sector. The Japanese could build up robust industrial corporate due to a strong banking base.

Banks as custodian of money: Banks are the custodians of the money of their depositors and have a moral obligation to make a prudent application of depositors' funds. That is why banks stand on a different platform than other companies. Whenever the banking sector gets struck into a crisis, the Governments have to act faster to salvage them before the entire banking system gets engulfed. For this reason, banking is a highly regulated industry.

Government dominance: Government has for long been dominant owner in the financial sector—whether it be banks or financial institutions. Gradually, it is divesting its equity holdings. As public participation in the holdings of financial sector entities goes up, good governance thereof becomes an issue of paramount significance.\textsuperscript{111}

4.10.3 Corporate Governance in Financial Institutions

“The question of efficiency and accountability of managements of financial institutions has gained prominence due to two major developments. The first is the report of S.H. Khan Committee on Corporate Governance and second is


the UTI's Communication to the companies in which it holds equity stakes suggesting that UTI's representation on this Board will be a precursor to good corporate governance. The Khan Committee has recommended that the FIs should themselves become role models. The FIs need to make several structural reforms in their governance organs such as the constitution of board committees, separation of the roles of CEO and chairperson, putting of majority of independent directors on credit and investment committees, etc. Moreover, RBI should be the sole financial regulatory authority over the FIs. The practice of nominating nominee-directors on the board of assisted enterprises has not been successful in preventing wrong or in promoting healthy norms of corporate decision-making.”

4.10.4 Basel Committee on Banking Supervision

“The Committee has emphasized that banking supervision cannot function well if sound corporate governance is not in place. It can be ensured by having appropriate levels of accountability, and checks and balances within each bank. Sound corporate governance can contribute to a collective working relationship between bank management and bank supervisors. The Basel Committee has further underscored the need for banks to set strategies for their operations and establish accountability for executing these. In addition, transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank.

This guidance refers to a management structure composed of a board of directors and senior management. The committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries as regards the functions of board of directors and senior management. The notions of board of directors and senior management in the context of a bank are taken to represent two decision-making units.”


4.10.5 Corporate Governance in Public Sector Banks

A substantial chunk of Indian banking sector still remains under the control of public sector banks despite the entry of some private banks in the arena. Major shareholding of public banks is with the Government. The public banks are new to the concept of corporate governance. Basel Committee has underscored the need for the banks to establish strategies and to become accountable for executing them. Transparency is vital to accountability so as to enable market participants to judge the management of a bank. The existing legal institutional framework of public sector banks is not aligned with principles of good corporate governance. So far banks have been burdened more with “social responsibility" and compelled to tow the line of thinking dictated by the political party in power. Healthy banking policies had been the last priority. Monopoly of public sector banks in banking business has protected them from competition and the bank managements have thereby become complacent. Lack of accountability and transparency has led to colossal amounts of non-performing assets (NPAs). The scheduled commercial banks in India have NPAs of over Rs. 70,900 crores which are seriously impacting their profitability. Steps are being taken to hasten recoveries under the new Act, Securitization and Reconstruction of Financial Assets and Enforcement of Security interests. RBI nominees on the Boards of banks have been concerned merely with preventing banks from committing any breach of quantitative guidelines than with the framing of strategic policies. Studies have, however, given evidence both against excessive regulation and deregulation.

The international consensus on preserving the soundness of banking system has highlighted the following as prime necessities:

- Effective risk management system;
- Adequate capital provision;
- Sound supervision and regulation;
- Transparency of operations;
- Conducive public policy intervention and maintenance of macro-economic stability in the economy;
• Establishment of strategic objectives and a set of corporate values that are communicated to the entire banking organization;
• Existence of appropriate oversight by senior management;
• Independent and qualified directors who are not subject to undue influence from management or outside concerns;
• Careful attention to the audit work done by internal and external auditors as an important control function.

In the light of the above, it may be useful to examine the approach of State Bank of India to corporate governance. In its Annual Report for the year 2000-01, the State Bank has stated that it is committed to the best practices in the area of corporate governance. The Bank believes that proper corporate governance facilitates effective management and control of business. This in turn enables the bank to deliver the best results to all its stakeholders. These objectives can be summarized as under:
• To enhance shareholder value.
• To protect interest of shareholders and other stakeholders including customers, employees, RBI and society at large.
• To ensure transparency and integrity in communication and to make available full, accurate and clear information to all concerned.
• To ensure accountability for performance and to achieve excellence at all levels.
• To provide corporate leadership of highest standard for others to emulate.
• The Bank is committed to:
  • Ensure that the Bank's Board meets regularly, provides effective leadership, exercise control over management and monitors executive performance
  • Establish a framework of strategic control and continuously review its efficacy
  • Establish clearly documented and transparent management processes for policy development, implementation and review, decision making, monitoring, control and reporting
  • Provide free access to the Board to all relevant information, advice, resources as are necessary to enable it to carry out its role effectively
• Ensure that the Chairman has a line of responsibility for all aspects of executive management and is accountable to the Board for the ultimate performance of the bank and implementation of the policies laid down by the Board. The role of the Chairman is also guided by the SBI Act, 1955 with all amendments.
• Ensure that a senior executive is made responsible to the Board to ensure compliance with all applicable statutes, regulations and other procedures, policies as laid down by the Board and report deviation, if any, to the Board.

4.10.6 Corporate Governance in Private Sector Banks

Entry of private sector banks has introduced an element of competition in the banking sector too. Private sector banks have entered niche areas, and being market-driven, they have been more transparent in their functioning. They have also been more tech-savvy, growth-oriented and have less of NPAs. However, these signals are not a permanent indication of the future scenario. The involvement of a leading private sector bank in the stock market scam has dispelled the wrong notion that private sector banks are a haven or a model of good governance.

The business of banking is unique in its nature since it deals with the money of others. It is necessary for the banks to adhere to strict ethical standards. It is the trust of the depositors that drives the industry. The situation as of now is that the banks have to still inculcate corporate governance principles in their functioning. The increasing competition however, making the banks aware of such need. Most of the banks are attempting to fulfill the bare legal requirements about disclosure, transparency and accountability. None of the banks has shown any initiative to set new standards. The extent to which the banks actually practice the professed corporate governance norms is still a debatable question. It is in this regard that both private sector and public sector banks compare well. Standards of Good Banking Practices, which are of significance to all types of banks, are as follows:-
• To ensure a fair and transparent relationship between the customer and the bank,
• To institute comprehensive risk management system,
• To proactively reduce customer complaints and evolve a scheme for redressal of grievances,
• To institute systems and processes to ensure compliance with the statutes concerning banking.”

4.10.7 Corporate governance in co-operative banks

“The board of directors of cooperative bank is primarily concerned with formulation of policies, within the circumference of byelaws. They give directions to and do overall supervision of the management performance, ensure transparency in overall functioning and financial aspects of the bank. The board should clearly define responsibility at all levels of the organization and ensure devotion there too. The Board members should not involve themselves in day-to-day management or operations of the bank. The code of conduct prescribing Do’s and Don’ts by directors should not be merely on paper but they should be practiced.

The board of directors should act as trustees to various stakeholders so as to enhance their values and protect the legitimate interest. The transgression of this fiduciary principle may create hazards to cooperative banks. The recent unfortunate episode of fall out of some Co-operative Banks had caused severe damage to cooperative movement. There are regulatory stringent provisions in State Cooperative Societies Act, which spell out various obligations and accountability of directors and the dire consequences for the breach of law.

The board of directors of cooperative bank should introduce the management information systems so as to ensure that it receives all key information on various matters, which have bearing on the bank. The board should set-up different committees of the board for discharging their duties and functions.

Problems in implementing Corporate Governance:
1. Inadequate understanding of banking principles, especially cooperative banking principles, at the level of directors and senior managements.

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3. Lack of knowledge for self-sustainable growth, with specific reference to prudential norms.

4. Lack of professionalism. Inadequate or no provisions in bye-laws to ensure the same.

5. Undue importance to interest of borrowers at the cost of stake of the depositors and members.


7. Politicization of cooperative banks. Majority of cooperative banks are affected by this lacuna. The cooperative banks are being used for fulfillment of political aspirations. It seems that there is inadequate hold for corporate governance.

8. For directorship more trust is given on electoral merit of the person rather than his professional abilities.

9. No restrictions on tenure of directorship. A person capable of being elected enjoys indefinite tenure.

10. Apathy of members/shareholders.

The major challenge to urban cooperative banks today is their capacity to integrate themselves with their national and global counterparts without sacrificing their own cultural ethos. Corporate governance plays crucial and vital role in this endeavor.\(^\text{115}\)

### 4.10.8 Sound Corporate Governance Practices

Following practices are based on supervisory experience with corporate governance problems at banking organizations and are critical elements of any corporate governance process. The Board should set up the strategies that will direct the on-going activities of the bank. The values should recognize the critical importance of having timely and frank discussions of problems. In

particular, it is important that the values prohibit corruption and bribery in corporate activities both in internal dealings and external transactions. The board of directors should ensure that senior management implements policies that prohibit (or strictly limit) activities and relationships to diminish the quality of corporate governance such as:

- Conflicts of interest;
- Lending to officers and employees and other forms of self-dealing (e.g., internal lending should be limited to lending consistent with market terms and to certain types of loans, and reports of insider lending should be provided to the board, and be subject to review by internal and external auditors); and

Providing preferential treatment to related parties and other favored entities (e.g., lending on highly favorable terms covering trading losses, waiving commissions)\(^\text{116}\)

### 4.10.8.1 Processes for Sound Corporate Governance Practices

- Setting and implementing clear lines of responsibilities and accountability throughout the organization.
- Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.
- Effectively utilizing the work conducted by internal and external auditors in recognition of the important control function they provide.
- Ensuring that compensation approaches are consistent with the banks ethical values, objectives strategy and control environment.\(^\text{117}\)
