Chapter 3

Literature Review and Conceptual Frame Work

- Introduction
- Literature Review
- Elements of corporate governance
- Corporate governance in Indian Banking Sector
- Corporate governance in search of a suitable definition
- Significance of Corporate governance
- Corporate governance and Financial sector
- Corporate governance and Banking: The Linkage
- Policy Framework of Corporate Governance in Indian Banking
- Corporate governance policy implementation in India
- The Model Policy for Good Governance in Bank
- Governance Rating Methodology
- Governance Cooperative Banking Vision
- Implementing Governance in Urban Co-operative Banks
- Step for Strengthening Through Corporate Governance in Co-operative Banks In India:
- References
Introduction

Currently, the way in which companies are managed and controlled in India is intensely being scrutinized consequently pushing the subject of corporate governance to the top of the agenda. The focus on corporate governance is particularly crucial in financial services and, most of all, in the banking sector since this sector has lately become highly exposed to public scrutiny and has learned, in a costly manner, the risk of attracting adverse publicity through failings in governance and stakeholder relationships.

Corporate governance is a crucial issue for the management of banks which should be looked at from two dimensions, that is their funding and, often, ownership of other companies as these make them a significant stakeholder in their own right. Research and Markets a renowned industry and market research organization, observed that governance in banks is a considerably more complex issue than in other sectors since banks will attempt to comply with the same codes of good governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control and compliance all have an impact on their matrix of governance.

Literature Review:

According to the Financial Stability Forum (2001), among the main factors the support the stability of any country’s financial system include:

- good corporate governance
- effective marketing discipline,
- strong prudential regulation and supervision,
accurate and reliable accounting in financial reporting systems,
- a sound disclosure regimes,
- the enforcement of effective laws,
- an appropriate savings deposit protection system.

Of particular interest to this study is *corporate governance*. Corporate
governance has been looked at and defined variedly by different scholars and
practitioners, however they all have pointed to the same end hence giving more
of a consensus in the definition. For example, the Financial Times (1997)
defines corporate governance as the relationship of the enterprise to
shareholders or in the wider sense as the relationship of the enterprise to society
as a whole, however, the Financial Stability Forum (2001) offers a definition
with a wider outlook and contends that it means the sum of the processes,
structures and information used for the directing and overseeing the
management of an organization. The OECD on the one hand, has defined
corporate governance as a system on the basis of which business companies are
directed and managed. It is upon this system that specifications are given for the
division of competencies and responsibilities between individual included
parties, such as the board of directors, the supervisory board, the management
and majority and other shareholders andformulates rules and procedures for
adopting decisions on corporate matters.

In another perspective, Arun and Turner (2002f) contend that there exist a
narrow approach to corporate governance which views the subject as the
mechanism through which shareholders are assured that managers will act in
their interests. However, Shleifer and Vishny (1997), Vives (2000) and Oman
(2001) observe that there is a broader approach which views the subject as the
methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment. There is a consensus, however that the broader view of corporate governance should be adopted in the case of banking institutions because of the peculiar contractual form of banking which demands that corporate governance mechanisms for banks should encapsulate depositors as well as shareholders (Macey and O’Hara (2001)). Arun and Turner (2002e) joins the consensus by arguing that the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behaviour of bank management. They argue further that the unique nature of the banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks. They posit that, in particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system.

This study therefore adopts the broader view and defines corporate governance (in the context of banking) as:

The manner in which systems, procedures, processes and practices of a bank are managed so as to allow positive relationships and the exercise of power in the management of assets and resources with an aim of advancing shareholder value and shareholder satisfaction together with improved accountability, resource use and transparent administration.
The Basel Committee on Banking Supervision (1999) state that from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

i. set corporate objectives (including generating economic returns to owners);

ii. run the day-to-day operations of the business;

iii. consider the interest of recognised stakeholders;

iv. align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and,

v. protect the interests of depositors.

The Committee further enumerates basic components of good corporate governance to include:

a) the corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;

b) a well articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;

c) the clear assignment of responsibilities and decision making authorities, incorporating hierarchy of required approvals from individuals to the board of directors;

d) establishment of mechanisms for the interaction and cooperation among the board of directors, senior management and auditors;
e) strong internal control systems, including internal and external audit functions, risk management functions independent of business lines and other checks and balances;
f) special monitoring of risk exposures where conflict of interests are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management or key decisions makers within the firm (e.g. traders);
g) the financial and managerial incentives to act in an appropriate manner, offered to senior management, business line management and employees in the form of compensation, promotion and other recognition;
h) appropriate information flows internally and to the public.

On a theoretical perspective corporate governance has been seen as an economic discipline which examines how to achieve an increase in the effectiveness of certain corporation with the help of organisational arrangements, contracts, organizational regulations and business legislation. It is not a disputed fact that banks are crucial element to any economy this therefore, demands that they have strong and good corporate governance if their positive effects were to be achieved.

King and Levine (1993a and b) and Levine (1997) emphasize the importance of corporate governance of banks in developing economies and observe that the importance is because:

- First, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth.
Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms.

Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy’s savings.

Fourth, many developing economies have recently liberalized their banking systems through privatization/disinvestments and reducing the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

Banking supervision cannot function if there does not exist what Hetteš (2002) calls “correct corporate governance” since experience emphasizes the need for an appropriate level of responsibility, control and balance of competences in each bank. Hetteš expounds further on this by observing that correct corporate governance simplifies the work of banking supervision and contributes towards corporation between the management of a bank and the banking supervision authority.

Crespi et al (2002) contend that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value-maximizing policies. They observe that these methods may be external to the firm, as the market for corporate control or the level of competition in the product and labor markets and that there are also internal mechanisms such as a disciplinary intervention by
shareholders (what they refer to as *proxy fights*) or intervention from the board of directors.

Donald Brash the Governor of the Reserve Bank of New Zealand when addressing the Conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector in London, June 2001 observed that:

“... improving corporate governance is an important way to promote financial stability. The effectiveness of a bank’s internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, almost every bank failure is at least partially the result of poor risk management within the bank itself. And poor risk management is ultimately a failure of internal governance. Although banking supervision and the regulation of banks’ risk positions can go some way towards countering the effects of poor governance, supervision by some external official agency is not a substitute for sound corporate governance practices. Ultimately, banking system risks are most likely to be reduced to acceptable levels by fostering sound risk management practices within individual banks. Instilling sound corporate governance practices within banks is a crucial element of achieving this.”
David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, observed in 2000 that:

“Corporate governance is of course not just important for banks. It is something that needs to be addressed in relation to all companies ... I do however believe that sound corporate governance is particularly important for banks. The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.”

One can find two main clusters of research related to our subject: one on assessment and quantification of governance quality in Russian banks, and the other on the interplay between governance and firm valuation.

Standard & Poor’s, the rating agency, has developed a methodology for appraisal and scoring of corporate governance resulting in corporate governance rating in two different scales – national and international [Standard & Poor’s, 2006]. The methodology includes the basic principles and criteria, and differentiates between country background and individual company analysis. The main 4 components of company analysis are: ownership structure and external influence; shareholders’ rights and the relations with affiliated persons; transparency, information disclosure and audit; and Board of Directors structure.
and effectiveness. The coverage of companies by corporate governance rating has remained extremely limited, and to date only one Russian bank has been awarded such a rating.

In 2008 Standard & Poor’s published its substantially modified methodology of corporate governance ratings under the name of GAMMA — Governance, Accountability, Management Metrics and Analysis [Standard & Poor’s, 2008]. The approach shifts its focus away from an abstract appraisal of governance in the given bank against the background of ‘best practice’ towards an analysis of specific risks taken by investor. GAMMA’s main components are: influence by shareholders; shareholders’ rights; transparency, audit and risk management system; and Board of Directors effectiveness, the process of strategizing, and compensation system.

Since 2004 the Russian Institute of Directors (RID) jointly with Expert-RA rating agency [RID & Expert-RA] have been awarding ‘national corporate governance ratings’ based on proprietary methodology.

Standard & Poor’s also publish regular surveys of transparency and disclosure of Russian banks. The latest survey [Standard & Poor's, 2007] covers the top 30 banks and aims to appraise the degree of disclosure of information relevant for investment community, against ‘international best practice’. The focus is on comprehensiveness and integrity of publicly available information on the main operational parameters, financial soundness, ownership structure and
corporate governance mechanisms. Although Standard & Poor’s explicitly warn that their transparency and disclosure score should not be used to gauge corporate governance quality, the two concepts have much in common and display a high degree of synchronization.

In 2007 the International Finance Corporation published its new survey of corporate governance in Russia’s banking sector [IFC, 2007], covering 82 private institutions. IFC examines commitment to good corporate governance; practices of the Supervisory and Management Board; transparency and disclosure; internal control and risk management; and shareholder rights. The survey stops short of awarding individual ratings to banks and comparing them against a common scale. This survey insightfully examines the practices of both the Supervisory and Management Boards and their interplay, while most other publications tend to limit their scope to the structure and practices of the Supervisory Board only.

The link between the quality of governance and the valuation of companies is sufficiently researched with regard to mature markets but much less so for emerging markets. Morcket al. [2005] reviews the large literature that explores the connection between country-level rules affecting corporate governance and firm behavior and the strengths of securities markets. Klapper and Love [2004] analyze connection between the measure of firm-level governance and share price on a cross-country basis. On the level of one emerging market country (Korea) Cho and Hasan [2005] examine the effect of ownership and governance on firm performance and discover evidence that: the extent of the foreign ownership level has a significant positive association with the bank return and a
significant negative association with the bank risk; the number of outside board of directors does not have any significant affect on performance; the presence of a foreign director on that board is significantly associated with bank return and risk.

Bernard S. Black has made a seminal contribution to the study of the impact of governance on firm valuation in Russia and other emerging markets [Black, 2001; Black et al., 2006]. In order to obtain a combined index of governance in Russian firms, 6 indices produced by 6 different agencies for irregular periods are standardized and put together. Black et al. [2006] finds an economically important and statistically strong correlation between governance and market value. However, it matters a great deal how one measures governance.

Staryuk uses the value-based management concept to research how corporate governance has driven the stock market valuation of the Russian ‘blue chip’ companies [Staryuk, 2008]; banks are not covered.

In August 2008, Bokov and Vernikov made an attempt to explain the differences in the valuation of Russian banks from a quality of governance point of view [Bokov, Vernikov, 2008]. They discovered that strategic investors appreciate high concentration of ownership and stability of the management team, while broadly neglecting the features of the Board of Directors as well as bank transparency. This article is a revised version of the above-referred conference paper.

The topic of corporate governance is receiving heightened attention\(^1\). Although much of what is said applies also to banks, it is true that the banking firm has
significant differences with respect to corporations in other economic sectors, and this justifies a special interest in its governance problems; Prowse (1997), Adams and Mehran (2002). For example, there is a clear conflict inside the banks between the interests of the shareholders and the interests of the depositors, with the former being disposed to take high-risk projects that increase share value at the expense of the value of the deposits. Small deposits are insured and banks are regulated, to avoid crisis of confidence and bank runs, although it increases the moral hazard problem, as it was shown in the Savings and Loan crisis in the U.S. Whether regulation substitutes or complements traditional governance mechanisms and controls is a subject of debate, but it is generally agreed that the external controls coming from takeovers and product market competition turn out to be weaker in banks than in other firms; Prowse (1997). Good governance relies more on the workings of internal mechanisms, such as the supervision and the control exercised by the board of directors, along with the regulatory constraints. Our paper focuses on those governance mechanisms that are implemented by the board such as the replacement of managers and directors when a bank’s economic performance does not meet the owners’ expectations.

Following previous work in this subject, we assume that internal control works properly if the probability of a significant board turnover, or the dismissal of a top executive, is inversely related to the economic performance of the bank, measured in terms of accounting rates of return$^3$. We also consider a friendly merger of banks as an intermediate control mechanism, somewhere in between the internal mechanisms and the external ones. This is so because mergers must be approved by the governance bodies of the bank, and also because the target bank’s assets are transferred to the acquiring company. For this scenario, we assume that good governance will predict that the likelihood that a bank merges
(and, therefore, its assets be transferred to another bank), increases with a lower economic performance of the target bank.

An important distinctive feature of our approach is that we compare the workings of governance mechanisms for three different forms of bank’s ownership, Independent Commercial banks, Subsidiaries (or Dependent banks) and Savings banks, which represent a case of a lack of ownership. This comparison is unique in the existing literature since the previous papers consider only one form of ownership at a time. Independent Commercial banks are privately owned banks whose shares are in the hands of families, individual investors and institutional investors. A bank is identified as Dependent when it has another bank (either national or international) as a controlling shareholder. Finally the Savings banks, “Cajas de Ahorros”, can be considered as “commercial non-profit organizations” in the sense of Hansmann (1996).

The Cajas control about half of the Spanish retail banking market. They compete for loans and deposits among themselves and with Commercial banks. Unlike Commercial banks, however, Savings banks must either retain their earnings or invest them in social and cultural programs (around 25% of their net profits go each year to these programs). They have no formal owners and there is no market then for corporate control of Savings banks. Moreover, the general assembly and the board are both composed by representatives from four stakeholder groups: public authorities, depositors, employees, and founding entities. Therefore Spanish Savings banks display several important features. First, they are not-for-profit organizations with a social contribution, coming from their profits as an extra tax. Second, they have no owners and are immune to the market for corporate control, with the exception of friendly takeovers or mergers by other Savings banks. Lastly, and quite importantly, they must respond to potential
conflicts of interests among their multiple stakeholders, who have “voice” inside the governance mechanisms. This paper examines how such differences translate into economic performance, and it also provides comparative evidence on the relationship between management turnover and mergers on one side, and economic performance on the other.

The Subsidiaries of other banks are legally independent firms that have a hierarchical relation with the parent bank. Some of them are subsidiaries of foreign banks, such as Barklays bank, and others are subsidiaries of other Spanish banks such as Banesto, which is now owned by Banco de Santander. These firms’ managers are closely supervised by the management team of the parent bank and, therefore, they can be considered lower level managers of a holding company. Within Commercial banks, we are able to compare the role of accounting measures of performance in personnel administration decisions, such as the dismissal of lower level managers, those in charge of the subsidiaries, and of top level managers, like the chairman and CEO of the Independent banks.

**Elements of corporate governance**

Different authors and management specialists have argued that corporate governance requires laid down procedures, processes, systems and codes of regulation and ethics that ensures its implementation in organizations. Some suggestions that have been underscored in this respect include the need for banks to set strategies – which have been commonly referred to as corporate strategies - for their operations and establish accountability for executing these strategies. El-Kharouf (2000) while examining strategy, corporate governance
and the future of the Arab banking industry, points out that corporate strategy is a deliberate search for a plan of action that will develop the corporate’s competitive advantage and compounds it.

In addition to this, the BCBS (1999) contends that 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. The Committee advances further that various corporate governance structures exist in different countries hence there is no universally correct answer to structural issues and that laws do not need to be consistent from one country to another. Sound governance therefore, can be practiced regardless of the form used by a banking organization. The Committee therefore suggest four important forms of oversight that should be included in the organizational structure of any bank in order to ensure the appropriate checks and balances and these include:

1) oversight by the board of directors or supervisory board;
2) oversight by individuals not involved in the day-to-day running of the various business areas;
3) direct line supervision of different business areas, and;
4) independent risk management and audit functions.

In summary, they demonstrate the importance of key personnel being fit and proper for their jobs and the potentiality of government ownership of a bank to alter the strategies and objectives of the bank as well as the internal structure of governance hence the general principles of sound corporate governance are also beneficial to government-owned banks.
The concept of good governance in banking industry empirically implies total quality management which includes six performance areas (Khatoon, 2002). These performance areas include capital adequacy, assets quality, management, earnings, liquidity, and sensitivity risk. Khatoon argues that the degree of adherence to these parameters determines the quality rating of an organization.

According to Tsui and Gul (2000), corporate governance mechanisms including accounting and auditing standards are designed to monitor managers and improve corporate transparency. A number of corporate governance mechanisms have been identified analytically and empirically. These, according to Agrawal and Knoeber, (1996), may be broadly classified as internal and external mechanisms as summarized in figure 31.1
Figure 3.1: Corporate Governance Mechanisms

(i) Determined by outsiders

- Institutional Shareholding
- Outside Block Holdings
- Takeover Activity

(ii) Determined by Insiders

- Insider Holdings
- Board size etc
- Debt Financing
- Outside Markets For managerial Talents

- Non-executive Directors
- Audit Committee
- CEO Tenure And horizon
- Audit Quality
Corporate governance in Indian Banking Sector

Impact of corporate governance (cg) policies of financial markets and institutions including bank specific governance policies, and impact of other governance related macro economic policies on the financial performance of banks are yet to come in literature. All the bank specific governance policies are likely to have direct bearing on the financial performance of banks. Similarly, many other policies which directly affect the principal functions of the banks and consequently their governance are also supposed to have some relationships. Most of the studies in the arena of cg are found to be conceptual in nature and few of them are in banking. Further, empirical evidences for banking are not distinctly visible in the financial literature. A study on the developing economies, Arun and Turner (2003), while suggesting for more foreign entry opined that it is imperative that governance should be in place to have more reform. Political interference and state ownership are identified as the major impediments in the bank governance of these economies.

It is established that in many countries the controlling share holders are dominating the interest of minority share holders of banks and govt. ownership is associated with lower financial development (La Porta et al. 1999 and 2002), thus bringing governance in to fore front. Bies (2002) observed that quality of accounting and auditing practices is sine qua non for maintaining confidence of financial markets and good cg can help in managing risk in a better way.

In India Das and Ghosh (2004) tried to establish a linkage between CEO compensation and bank performance and concluded that CEOs of poorly performing banks are likely to face higher turnover than the CEOs of well-
performing banks. As there is a dearth of impact studies of cg policy implementation on financial performance of banks, more particularly in Indian context, this study is an attempt to fill the gap.

Several policy measures undertaken by Indian regulators in both the segments of the market are expected to be visible in the indicators of important financial institutions. Banking being the most crucial segment in our economy most of these exercises could have impacted their important financial parameters. The need is thus arises to assess the cg policy impact on some these variables, both qualitatively and quantitatively. The former is attempted with the help of a survey method by analysing the status of cg as on 2001, various recommendations of the committees set up by RBI and the action taken by RBI on these recommendations. The latter is tried with by establishing a relationship between the financial performance parameters of banking with the sector specific cg policies. The period of the study is taken from 1998-99 to 2004-05. The analysis of the impact of other macro economic policies on the two basic functions of banking viz. deposit taking and loan disbursement, which ultimately bring cg into picture, are also tried. The analysis is made to test the hypothesis that cg policies do not have any impact on the performance of Indian banking.

The schematic arrangement of this paper is made in five sections. The first section tries to identify the linkage between cg and the financial sector, with a special emphasis on banking. The second devotes to the policy developments in this field in India. Third section, with the help of statistical analysis establishes the relation between cg and bank performance parameters over last seven years. The next section details two major macro economic policy decisions and their
possible linkage with bank governance and performance. The last, brings some random observations and concluding remarks.

**Corporate governance in search of a suitable definition**

The discussion on governance has absorbed most of the economies for more than a decade. Traveling through the pre-1992 American discussions on disassociation of power and money (emanated from the Watergate scandal), post-1992 Cadbury Report on governance codes and OECD principles (1998&1999), cg has not yet settled at any universal accepted definition. Because there are so many varying views on what cg is as a definitive product, there is no globally applicable definition of cg (Barnier, 2001). In fact, the very definition of cg stems from its organic link with the entire gamut of activities having direct or indirect influence on the financial health of corporate entities (Kamesam, 2002). Cadbury Report (1992) simply described cg as “the system by which companies are directed and controlled”. It can be confined to the ‘ Corporate Governance Tripod’ , that is, the relationship between shareholders, directors and management, an increasing number of definitions refer to the fact that many other groups have an interest in the company (Van den Berghe, De Ridder, 1999). It is “…an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders” (Cochran and Wartick, 1988). It is “the system by which business entities are monitored, managed and controlled” (RBI, 2001). It is “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Cg also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good cg should
provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”(OECD, 1999). In its broadest sense, governance refers to the "range of institutions and practices by which authority is exercised to satisfy the interest of all the stake holders including the society" and its meaning is shaped by the specific value system prevalent in the country.

**Significance of Corporate governance**

No matter what view of the corporate objective is taken, effective governance ensures that boards and managers are accountable for pursuing it. The role of effective cg is of immense significance for the society as whole. At first place it promotes the efficient use of scarce resources both within the organisation and the larger economy. Secondly, it makes the resources flow to those sectors or entities where there are efficient production of goods and services and the return is adequate enough to satisfy the demands of stake holders. Thirdly, it provides a broad mechanism of choosing the best managers to administer the scarce resources. Fourthly, it helps the mangers to remain focused on improving performance, making sure that they are replaced when they fail to do so. Fifthly, it pressurises the organisation to comply with the laws, regulations and expectations of society and last but not the least it assists the supervisors to regulate the entire economic sector without partiality and nepotism.
### Table – 3.2

<table>
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<tr>
<th>Dimensions</th>
<th>Impact on Cost of capital</th>
<th>Impact on Risk Profile</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Corporation</td>
<td>Greater realization of Business opportunities.</td>
<td>More investor and creditor confidence provides additional resistance to adverse market conditions.</td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Economy</td>
<td>Higher profitability. Greater realization of growth opportunities because of impact on domestic and foreign investment.</td>
<td>Affects resistance to internal and external shocks influencing threshold of capital flight.</td>
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When institutions in any economy, be it public or private, mis-manage themselves it is said that they are not properly governed. The problems of poor governance are matter of concern in most of the developing and underdeveloped countries and so also in India. Tabel-1 depicts the dimensional significance of cg for corporations as well as for the economy. The improvement in overall governance culture in the entire economic system helps the sub systems to function efficiently. By providing an appropriate structure in any system, cg sets right objective and devises the means of attaining them. In this process it helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. It also boosts the confidence of investors, which encourages them to remain with the economic system. It reduces the risk of capital flight from an economy and increases the flow and variety of capital in the economy, as a result, the cost of capital becomes lower for the firms/corporations. The degree of adherence to the basic principles of governance at the corporate level enhances the confidence of the investors, both domestic and international, and ultimately they get capital at better term. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and other important aspects of the corporations. An adequate and strong disclosure therefore helps to attract capital and maintain confidence of investors. High-quality communications reduce investors’ uncertainty about the accuracy and adequacy of information being disseminated and thereby help the firms to raise adequate capital at a competitive cost.
Corporate governance and financial sector

Ensuring effective governance in financial sector is sine qua non for any economy’s growth and development. It assumes more significance because of its greater dominance as well as the magnitude of repercussions on the economy, in case of their failure. Special emphasis is given to this sector because of the unique character of financial intermediaries and the added complexity of standard governance problems among financial institutions. For example, questions of transparency, incentive conflicts, and agency conflicts in the corporate sector are compounded by greater opacity, government ownership, and regulation of financial institutions, banks in particular. In addition, the costs of poor governance in the financial sector are much more widespread than are those of individual corporations. Because financial intermediaries are the repositories of household wealth, their losses or failures can lead to large systemic and social costs.

Financial sector governance is important for several clear and obvious reasons. One critical reason is to avoid financial crises—the failures of large numbers of financial institutions or the sudden and sharp collapse of prices of financial instruments traded on capital markets. As emphasised by Litan, Pomerliano and Sunderrajan (2002) financial institutions must function effectively, because they operate the payments system and store much of the wealth in any society. Likewise, capital markets are also instrumental in enabling companies to raise funds and investors to hold or access their wealth. In a very real sense, therefore, financial sectors are the functional equivalent of circulatory systems in human beings.
Governance in financial sector encompasses the governance of its constituent markets and their stake holders. Banking sector being the dominant and vital segment deserves utmost attention. Banking is the systemic institution not only possesses the potential of a great catalyst of growth but also on the other hand has the capability of causing catastrophe to an economy. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Governance affects banks’ valuation and their cost of capital thereby affects the cost of capital of the firms and households they lend to. Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development (Levine, 2003). Research finds that banks are critically important for industrial expansion, the cg of firms, and capital allocation. However, the importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets.

**Corporate governance and Banking: The Linkage**

No type of country has been free of costly banking crisis in the last quarter century. The prevalence of banking system failure has been at least as great in developing and transition countries as in the industrial world (Honohon and Daniela, 2000). The developments of new technologies, major industry consolidation, globalization, and deregulation have placed the banking industry at a strategic crossroads. Therefore, banks face a more competitive, volatile global environment than other types of corporations. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions.
The banking sector in general, is highly sensitized to public scrutiny and is more vulnerable to the risk of attracting adverse publicity through failings in governance and stakeholder relationships. It is a special sub-set of cg with much of its management obligations enshrined in law or regulatory codes. In the light of the above statement governance issues in banks, more particularly in PSBs assume immense significance, but unfortunately these are less discussed and deliberated. Although the primary reason identified to it is the prevalent of govt. ownership across the institutions, another important reason can be attributed to the multiplicity of regulatory and supervisory legislations. For instance in India there are 5 legislations e.g. RBI Act, SBI Act, Bank Nationalization Act, Banking Regulation Act and Companies Act, govern the banking sector. Because of this multiplicity of Acts and their enforcing agencies i.e. RBI and GoI, any concrete form of principles on bank governance is yet to emerge.

Why banks pose a special governance problem that is different from ordinary corporations? First, banks’ activities are less transparent and thus more difficult for shareholders and creditors to monitor. It becomes more opaque when the largest chunk of share capital is with government. Second, because governments heavily regulate banks, ownership may be dispersed by mandate and thus takeovers may be impeded, directly or through prohibitions on bank ownership. Third, the protection of bank deposits by government can undercut incentives for depositors to monitor management, thus shifting responsibility for governance of banks to other parties or institutions. Fourthly, banks also differ from most other companies in terms of the complexity and range of their business risks, and the consequences if these risks are poorly managed.
Thus governance of banks is quite distinct from the rest of players of financial sector. Because of the complexity of its business, driven by government holdings, opacity of books of accounts and plethora of regulations of financial institutions, this constituent brings serious questions into the transparency, disclosure and agency relationship. Depositors do not know the true value of a bank’s loan portfolio as such information is incommunicable and very costly to reveal, implying that a bank’s loan portfolio is highly fungible (Bhattacharya et al, 1998). The opaqueness of banks also makes it very costly for depositors to constrain managerial discretion through debt covenants and for the diffuse equity holders to write and enforce effective incentive contracts or to use their voting rights as a vehicle for influencing firm decisions (Caprio and Levine, 2002). Information asymmetries are also larger with banks (Furfine, 2001). A further issue is that the interests of bank shareholders may oppose those of governmental regulators, who have their own agendas, which may not necessarily coincide with maximising bank value. Shareholders may want managers to take more risk than is socially optimal, whereas regulators have a preference for managers to take substantially less risk due to their concerns about system-wide financial stability. The Indian experience so far does suggest that government ownership, with its relatively muted emphasis on wealth maximization, might conduce to a trade-off between efficiency and stability in banking (Ram Mohan, 2002).

Due to this special nature of problem the broader view of cg, which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment (Shleifer and Vishny, 1997) can be extended to this sector. Tracing the special problems with banking organisations, Macey and O’ Hara
(2003) argue that because of the peculiar contractual form of banking, a broader view of cg should be adopted and the cg mechanisms for banks should encapsulate depositors as well as shareholders. They emphasised that the scope of the duties and obligations of bank directors and officers should be expanded to ensure the safety and soundness of banks. The view of Basel committee (1999) on cg is holistic and details how banks a) set corporate objectives (including generating economic returns to owners); b) run the day-to-day operations of the business; c) consider the interests of recognised stakeholders; d) align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and e) protect the interests of depositors.

Distinctions on cg orientations are found in most of the developing countries, but particularly they are quite prominent where there is a dominance of public sector in banking industry, like India. This dominance ultimately breeds the weak cg arrangements in banking systems (Mortlock, 2002), which include: i) inadequately qualified and experienced bank directors, and directors with significant conflicts of interest; ii) insufficient understanding of the nature of banking risks by a bank’s directors and senior management; iii) inadequate representation of non-executive and independent directors on the board (i.e directors unconnected to parties related to the bank); iv) inadequate risk management systems, internal controls and internal audit arrangements; v) insufficient structures for ensuring appropriate scrutiny and management of conflicts of interest, including those arising in business dealings between banks and related parties; vi) insufficient accountability of directors for the stewardship of their bank; vii) inadequate oversight of senior managers by boards of directors, and poor quality financial and risk-related reporting to the
board; and viii) insufficient rights for shareholders, including in respect of access to information and the ability to hold the board of directors to account. All these weaknesses can be traced distinctly to the functioning of PSBs in India. Although PSBs attempt to comply with the same codes of board governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control and compliance all have an impact on their matrix of governance. It has been observed that 63 percent of PSBs have potentials for profitability increase through efficiency improvement (Kumar & Verma, 2003), which ultimately depends on the quality of governance.

The reality that various cg structures for banks exist in different countries reflects that there are no universally correct answers to structural issues and that law need not be consistent from country to country. Recognizing the diversity in structure of governance mechanism across the countries the Basel Committee (1999) recommended four important forms of oversight that should be included in the organisational structure of any bank in order to ensure the appropriate checks and balances: (i) oversight by the board of directors or supervisory board; (ii) oversight by individuals not involved in the day-to-day running of the various business areas; (iii) direct line supervision of different business areas; and (iv) independent risk management and audit functions. In addition, the committee also emphasizes on the importance of key personnel being fit and proper for their jobs.

It is also found that in most of the countries cg is inadequate in banks, more specifically in developing economies. One of the more common underlying causes of this is insufficiently developed governance law, including inadequate
specification of directors’ duties, insufficient clarity of the rights of shareholders and other stakeholders, and insufficient specification of the obligations for dealing with conflicts of interest. In addition, inadequate enforcement of cg law possibly as a result of poorly resourced judiciary and government authorities also impedes the effectiveness of cg. Besides, inadequate development and promotion of a cg culture by the relevant professional associations (such as banking associations), absence of cultural empathy towards the observance of governance principles, and excessive intrusive financial sector regulation (as prevailed in pre-liberalization phase of India) and supervision are some of the contributing factors. Similarly, poorly developed financial disclosure arrangements in these countries also weaken the incentives for the directors and senior management of banks to maintain sound cg and risk management practices.

Tracing the importance of cg in Indian banks quite a few facts are discerned. First, banks have an overwhelmingly dominant position in financial systems, and are extremely important engines of economic growth (King and Levine, 1993; and Levine, 1997). Second, as financial markets are usually underdeveloped, banks are typically the most important source of external finance for the majority of firms. Third, the economy is dominated by many small scale firms and most of them depend on banks. The governance of banks thus affects their governance structure. Fourth, as well as providing a generally accepted means of payment, banks also function as the main depositories for the economy’s savings. Fifth, India has recently liberalized its banking systems through privatization/disinvestments and hence reducing the role of economic regulation. Economic regulations are getting replaced by prudential regulations, like capital adequacy norms, supervisory norms and many others. However, the
prudential reforms already implemented in developing countries including India have not been effective in preventing banking crises (e.g. the recent Global Trust Bank and other cooperative banks failures) and the reasons can be traced to many, like poor legal structure, dominance of a docile share holder i.e. Government, and asymmetry in information flow across the stake holders. Although in comparison to many developing countries India is better placed with respect to taping the capital market for fulfilling necessary capital requirement, the need arises here to make the regulations strengthened and the governance to more effective.

The concern for good governance from the state can be visualized from its oversight functions. In India the oversight function of Govt. is conditioned by three reasons (Leeladhar 2004). Firstly, it is believed that the depositors, particularly retail depositors, are not able to effectively protect themselves as they do not have adequate information, nor are they in a position to coordinate with each other. Secondly, bank assets are unusually opaque, and lack transparency as well as liquidity. This condition arises due to the fact that most bank loans, unlike other products and services, are usually customized and privately negotiated. Thirdly, it is believed that that there could be a contagion effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy. As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, resulting in a run on the deposits and putting the entire financial system in jeopardy. Despite of such concerns from govt. side, the dominance of the latter and its central bank casts several doubts over their intentions.
Another area of concern in Indian banking is the dominance of state owned banks. Government ownership thwarts competitive forces, limits the effectiveness of government supervision in the financial sector, and tends to increase the opacity of banks’ operations. Governments use their state-owned institutions to support excessive government spending and favor less-than-creditworthy borrowers. All of these tendencies dampen overall economic growth (Litan et al, 2002). Even for other categories banking institutions not owned by Government, the former Governor of RBI observed that “Old private sector banks also have very poor auditing and accounting systems. New private banks – generally good on accounting, but poor on accountability. More modern and computerized, but less risk conscious. One thing which is common to all is that cg is highly centralized with very little real check on the CEO, who is generally also closely linked to the largest owner groups. Boards or auditing systems are not very effective.” (Jalan 2002). The enormous consequences of poor governance of banks come to limelight only in case of banking crises/failures. It is of crucial importance therefore that banks have stronger cg than other corporate entities.

**Policy Framework of Corporate Governance in Indian Banking:**

**Committee Recommendations and Implementation**

The global policy formulation on this issue can be traced to the industrialized countries. Blue Ribbon Commission of US, Cadbury Committee from UK, and many stock exchanges around the world started flouting governance principles and the World Bank and OECD tried to give all the principles in a comprehensive framework. India started its ground work for cg principle implementation after many years of the implementation of Codes of Best Practices developed the Cadbury Committee, 1991. Considerable attention has
been given to cg in India in recent years. In addition to the Advisory Group chaired by Dr. R.H. Patil (RBI, 2001) and Consultative Group of Directors of Banks/ Financial Institutions (Ganguly Group, RBI, 2002), several official Committees have already gone into the issues relating to cg and have given their Reports. These include the Committee chaired by Shri Kumar Mangalam Birla (SEBI, 1999), the Task Force on Corporate Excellence through Governance (GOI, 2000), Naresh Chandra Committee on Corporate Audit and Governance (SEBI, 2002), Naresh Chandra Committee-II on Regulation of Private Companies and Partnership (GOI, 2003) and Narayana Murthy Committee on Corporate Governance (SEBI, 2003). Recently, Malegam Committee has gone into disclosure norms for offer documents (SEBI, 2004) that would also contribute towards improving cg in the country. Preceding these official committees, the industry association, CII, had itself provided a Code in 1998 (RBI, 2004).

Governance principle formulation exclusively for banking came little late. Although some regulations were issued by the Basel Committee on Banking Supervision (BCBS) way back in 1988, these were not considered as exclusive cg principles. The Basel banking regulations issued in 1999, however, brought an array of principles over a broad spectrum of banking activities. The OECD principles also tried to fulfill some of the requirements of banking industry. Keeping in view the widely accepted Basel recommendations in the background many countries framed their own set of governance principles for their banking industries. For Indian banking the RBI has taken the sole responsibility of framing policy in this regard. The Standing Committee on International Financial Standards and Codes which was set up in 1999 to bring common financial standards in line with international practices constituted an advisory
committee on cg under the chairmanship of R.H.Patil. The sub-committee submitted its report in 2001 after reviewing the governance models of East Asian countries, U.S., U.K., and other European countries. The Report has observed that since most of the Indian companies belong to the “insider” model of East Asia i.e. dominance of family/promoter ownership and control, it is essential to bring quick reforms in the corporates/banks/financial institutions/public sector enterprises to make them more autonomous and professional (RBI,2001). The Group looked into public sectors banks and noted that the first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. Furthermore, as a part of strengthening the functioning of their boards, banks should appoint a risk management committee of the board in addition to the three other board committees viz., audit, remuneration and appointment committees. Taking this move further, the Reserve Bank constituted a Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A.S. Ganguly) to review the supervisory role of Boards of banks and FIs. The Ganguly Consultative Group looked into the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees and suggested measures for making the role of the Board of Directors more effective (Gopinath, 2004).

Governance codes for banking are drawn from various committee reports as mentioned in the above paragraph. Besides, Reserve Bank of India has taken various steps furthering cg in the Indian Banking System. These can broadly be classified into the following three categories viz. a) Transparency b) Off-site surveillance and c) Prompt corrective action. Transparency and disclosure
standards are also important constituents of a sound cg mechanism. Transparency and accounting standards in India have been enhanced to align with international best practices. However, there are many gaps in the disclosures in India vis-à-vis the international standards, particularly in the area of risk management strategies and risk parameters, risk concentrations, performance measures, component of capital structure, etc. The off-site surveillance mechanism is also active 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. As against a single trigger point based on capita adequacy normally adopted by many countries, Reserve Bank in keeping with Indian conditions have set two more trigger points namely Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability.

**Corporate governance policy implementation in India**

Looking at the developments of governance practices and its implementations in India it is found that till the year 2002 most of them were at recommendatory stage. Most of the suggestions given by the Advisory Group (2001) and Ganguly Committee (2002) were implemented during and after the year 2002. The following paragraphs highlight the status of bank governance as envisaged by the Advisory Group (2001), their recommendations, and the action taken by RBI for their implementation.
## Table - 3.3

### Governance status in Indian Banking

<table>
<thead>
<tr>
<th>Governance variables</th>
<th>Governance Status, 2001</th>
<th>Committee recommendation</th>
<th>Action Taken by RBI Between 2002 and 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Responsibility of the Board</td>
<td>Board members are not effective as ideally envisaged. This is more visible in PSU banks.</td>
<td>Boards to align their responsibilities in line with international best practices. Boards are to play very active role in providing oversight to senior level management for managing different risks. Limits for individual voting rights are 1 per cent in PSBs, but 10 per cent for private sector banks.</td>
<td>Recommendations of the Ganguly Group have been forwarded for implementation. Directors to execute the deed of covenants to discharge their responsibilities to the best of their abilities, individually and collectively.</td>
</tr>
<tr>
<td>2. Accountability of the Board to shareholders/stakeholders</td>
<td>Boards of majority of the banks do not fulfill clear lines of responsibility and accountability for themselves.</td>
<td>The board should be accountable to the owners of the bank. The bank should also keep in view the interests of main stakeholders, such as, depositors, employees, creditors, customers, etc.</td>
<td>The Chairman of the Audit Committee should be present at AGMs to answer shareholder queries. Banks have also been advised to form committees under the chairmanship of a non-executive director to look into the redressal of complaints.</td>
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<tr>
<td>3. Election to the board</td>
<td>PSU Boards formed by the Government and through nomination. In private sector banks appointments are governed by Banking Regulations Act, and the companies Act. One director each is</td>
<td></td>
<td>the process of selection with clear and transparent criteria. Such criteria for choosing non-executive directors should be disclosed in the Annual Report. They should be independent and</td>
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</table>
nominated to the boards of private sector banks by RBI. 

elected and have different tenures to ensure continuity.

and proper’ criteria for appointments/ renewal of appointments to Board. They should undertake a process 
of due diligence in regard to the suitability for the appointment of directors. The Boards of banks should 
form nomination committees to scrutinize declarations of candidates.

All banks should have minimum of 10 board members. Increasing number of professionals on Boards 
by specifying proportion of non-executive members on Boards as in case of other companies.

Apprised GOI on this issue and the matter is being followed up by the concerned agencies. RBI 
directions on ‘fit and proper’ criteria for board appointments have been issued.

All banks should have a specified proportion as non-executive independent directors as in case of the 
other companies. Representation of private shareholders is required in case of mixed ownership.

The Ganguly Committee recommendations are communicated to banks.

Issued circular annexing the mandatory recommendations of the SEBI Committee on Corporate Governance. It implies that in case a

<table>
<thead>
<tr>
<th>4. Size of the Board</th>
<th>The sizes of the 1 Boards of PSU banks are stipulated by their respective statues.</th>
<th>All banks should have minimum of 10 board members. Increasing number of professionals on Boards by specifying proportion of non-executive members on Boards as in case of other companies.</th>
<th>Apprised GOI on this issue and the matter is being followed up by the concerned agencies. RBI directions on ‘fit and proper’ criteria for board appointments have been issued.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Composition of the Board</td>
<td>Not less than one half of the total number of directors of banks shall consist of persons who have special knowledge or practical experience.</td>
<td>Banks should have a specified proportion as non-executive independent directors as in case of other companies. Representation of private shareholders is required in case of mixed ownership.</td>
<td>The Ganguly Committee recommendations are communicated to banks.</td>
</tr>
<tr>
<td>6. Independence of directors</td>
<td>Disclosure</td>
<td>The recommendation of Blue ribbon commission shall be applicable. The directors nominated by the government on the boards of PSBs and all nominees of the regulators should not be</td>
<td>Issued circular annexing the mandatory recommendations of the SEBI Committee on Corporate Governance. It implies that in case a</td>
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<td>Process relating to that case.</td>
<td>considered as independent. A majority of non-executive directors should be identified in the Annual Report.</td>
<td>company has a non-executive Chairman, at least half of the Board should be independent.</td>
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<tr>
<td><strong>7. Tenure for Directors and Age</strong></td>
<td>No mandatory provisions.</td>
<td>Tenure for independent Directors may preferably be up to ten years at a stretch. The age limit should be a maximum of 65 years for whole-time Directors and 75 years for part-time Directors. The liability of non-executive directors should be limited.</td>
<td>Whole-time Directors should have sufficiently long tenure. As per Banking Regulation Act, maximum tenure of non-executive Directors is eight years. Stipulated age limit of 35-65 years for non-executive Directors. The upper age limit has since been revised to 70 years.</td>
</tr>
<tr>
<td><strong>8. Multiple Board seats</strong></td>
<td>A person cannot be on the boards of two banking companies simultaneously.</td>
<td>One Director should not serve on more than 10 Boards or be member of more than 5-6 committees.</td>
<td>RBI has issued circular in June 2002 directing that a Director should not be in more than 10 committees or act as a Chairman on more than 5 committees.</td>
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<td><strong>9. Chairman and CEO:</strong></td>
<td>The Government controls the appointment.</td>
<td>Chairman and CEO should be separated positions</td>
<td>Requested GOI for legislative changes as the per Ganguly Group recommendation.</td>
</tr>
<tr>
<td><strong>10. Board Meetings</strong></td>
<td>Nationalised banks to have to hold at least six meetings in a year and at least once in a quarter.</td>
<td>At least six meetings in a year keeping aside the quarterly restrictions.</td>
<td>Made mandatory that Board meetings be held at least 4 times a year with a maximum gap of 4 months.</td>
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<tr>
<td><strong>11. Disclosure of Director Biographical Information</strong></td>
<td>No specific provision.</td>
<td>Details about the new director should be given in the general meeting of shareholders and also in the Annual Report.</td>
<td>Prescribed appropriate procedures for nomination. Disclosure for key management</td>
</tr>
<tr>
<td>12.Disclosure of remuneration</td>
<td>A number of banks do not disclose the entire compensation package of their full time directors.</td>
<td>Remuneration package of the directors should be disclosed in the Annual Report and they should be reported to shareholders and audited.</td>
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<tr>
<td>13.Audit Committee</td>
<td>Banks are yet to set up audit committee with right composition various directors.</td>
<td>Audit Committees should be formed as per recommendations of the Blue Ribbon Committee.</td>
<td></td>
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<tr>
<td>14.Remuneration Committee</td>
<td>No provision.</td>
<td>Boards should set up Remuneration Committees made up exclusively of non-executive Board members. Remuneration should be decided by the remuneration committee.</td>
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<tr>
<td>15.Financial reporting, Disclosure and Transparency</td>
<td>Standard of bank’s disclosure fall short of international standard. Some disclosures are made mandatory by RBI.</td>
<td>Financial reporting, disclosure and transparency of banks need further improvement. Disclosures as per accounting standards should cover subsidiaries, especially where 26 percent or more shareholding exists. Disaggregated segmental information should also be provided.</td>
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The Assessment

A cursory look at the preceding table reveals that before the financial year 2001, i.e. when the advisory group submitted its governance report the banking in India was devoid of most of the governance mechanisms or was operating with a weak framework of governance. Most of the recommendations were communicated during or after the year 2002 to the banks and GOI (for necessary legislative changes) for implementation either in toto or with some modifications. The post implementation scenario of Indian banking has of a mixed experience. While there is a handsome profit by most of the banks, particularly the public sector banks have shown very good results, at the same time the failure of Global Trust Bank brings the darker side of the governance and role of RBI. However, qualitative changes have been observed in disclosure practices by banks. Many of them have brought a separate section on cg in their annual reports and shown better accounting practices.

THE MODEL POLICY FOR GOOD GOVERNANCE IN BANK:

Speedy services in the matter of lending.

(1) Not to discriminate on

(2) To be fair and honest in advertisement

(3) To provide assistance or advice to customers applying for loans,

(4) Grievance redressal mechanism

(5) To comply with all the regulatory requirements in good faith.
The customer would be informed the procedure involved in servicing and closure of the loan taken.

The loan agreement would clearly stipulate that credit facilities are solely at banks discretion.

Bank would notify clearly about the penal interest rates applicable to prospective clients like rate of penal interest and circumstances under which they are payable etc.

Any revision modification in these charges would be notified in advance to customers through banks website; delivery points like branches and other media.

Before taking a decision to recall accelerate payment or performance under the agreement or seeking additional securities. Bank would give notice to borrowers, as specified in the loan agreement or a reasonable period, if no such condition exists in the loan agreement.

If such right of set off is to be exercised, borrowers shall be given notice about the same with full particulars about the remaining claims and the documents under which bank is entitled to retain the securities till the relevant claim is settled paid.

In case of receipt of request for transfer of borrower account, either from the borrower or from a bank / financial institution, which proposes to take over the
account, the consent or otherwise i.e., objection of the Bank, if any, shall be conveyed within 21 days from the date of receipt of request.

- If required under law
- If it is in the public interest to reveal the information
- If the interests of our bank require such disclosure

Financial distress:

- Bank would encourage borrowers to inform about their financial distress as soon as possible.
- Bank would adequately train the operational staff to give patient hearing customers in financial distress.
- Bank would look into cases of customers’ financial distress and consider on merits.

They do, however, have the responsibility to set the tone regarding their institutions risk taking and to oversee the internal will be followed. They also have the responsibility to hire individuals who they believe have integrity and can exercise high level of judgment and competence.

The management of Banks will need to adopt better systems and practices, and to provide necessary information and material to their boards for making sound decisions.

Important fact that they are the backbone of the national payment system.
Regulatory purview of the Central Bank of the country not only in India.

Interest of the depositors is of paramount importance

In times of distress, banks are generally given access to the safety net arrangements by the Reserve Bank of India or the Government of India.

Fact that banks are highly leveraged entities.

Governance systems and procedures are required to be much tighter in the banks and financial institutions.

Particularly to the rural and weaker sectors, cannot be lost sight of. It is in this context that the banks and FIS will continue to play a major role in meeting the broader expectations of the society and to this extent the regulator will be required to direct resources to these vulnerable segments.

**GOVERNANCE RATING METHODOLOGY:**

A system has been devised by which governance practices of companies are rated on the basis of following criteria.

**Management:**

Leadership and Strategy, Competence, Decision Making and organizational climate.
Ethics:

Written Code, Corporate Social Responsibility, Good Business Practices.

Customers:

Good Manufacturing / Services Practices and Customer satisfaction

Creativity and Innovation:

New product / Services, R & D Initiatives and other innovations

Financial Performance:

Wealth Creation, wealth Management and Wealth Distribution.

Disclosure Standards:

Adequacy and Compliances and Better Standards.

The process is in evolutionary stage and encourages Banks to get them rated from an independent agency.
GOVERNANCE COOPERATIVE BANKING VISION 

SHAPE THE BANK OF THE FUTURE :

The bank of the future will be shaped largely by the changes in the environment, economy, demography, regulatory, technological, and the systems and markets through which it operates. The Institute for Business Value, a research unit of IBM, has identified five key trends that will determine market success in 2015, viz (i) customers taking control, (ii) niche competitors, (iii) a new workforce, (iv) regulatory transparency, and (v) focus on technology.

In the last few years, no other industry has benefited from the advancement of technology as the banking industry. The widespread application of technology has helped banks cut costs, become faster, smarter, broader, overcome geographical barriers and become universal banks. Banking is more dependent upon technology than ever before, with annual global expenditure on technology running over $ 30 billion.

Draft Vision Document for Urban Co-operative Banks

Urban Co-operative Banks (UCBs) are an important part of the financial system in India. It is, therefore, necessary that the UCBs emerge as a sound and healthy network of jointly owned, democratically controlled, and ethically managed banking institutions providing need based quality banking services, essentially to the middle and lower middle classes and marginalized sections of the society.

This document sets out the broad approach and strategies that need to be adopted to actualize this vision to remain in competition.
The bright spot of year 2006 came in the fag end of the year when Maharashtra Government signed an MOU with the RBI, thus bringing nearly 85% of the urban banks in the country under the ensuring that a consultative machinery was put in place that would minimize, if not eliminate, the negative effects of dual control and provide a forum where the Federations also have a voice, the National Federation would like to work with all the

NAFCUB would also be in continuous interaction with the RBI for moving towards providing a genuine level playing field to urban cooperative banks that had hitherto been generally denied to them on account of, with RBI puts it as ‘lack of regulatory comfort’.

- NAFCB, as the apex federation, is committed to ensure that: The directors of urban cooperative banks are supported to equip themselves to oversee the working of their banks in a manner that would make the banks financially sound, socially responsible, and compliant with all the regulatory norms.

- The urban banks are able to leverage their unique position of grass roots level banking organizations with the help of technology up gradation, better HRD policies and professional outlook in management.

- The urban banks have an efficient aggregator of their resources, in the form of an apex banking institution, that can help the urban cooperative banks access the capital / money markets, participate in consortium advances, and help them get networked.
• Creation of such an institution has been contemplated by the working group on alternative avenues for capital, which felt that, like in many countries, where cooperative credit structure is well developed, the Indian context. It has recommended for another working Group to go into modalities of formation of such a bank.

• There is a new found confidence in urban cooperative banks. It is expected to improve in 2007. The sector, learning from past mistakes, is poised to take on the challenges of competition. If the regulators are supportive and permit them more avenues of doing business and earnings, the coming years would see that the urban cooperative banks regain their market share of 6.6% achieved in 1999-2000, from the present figure of 4.8%. Urban cooperative banks understand the importance of regulatory compliance and are striving to operate as per the norms. We are sure that the RBI is getting back the regulatory comfort, and will play a more development role, in addition to its regulatory functions.
Memorandum of Understanding (MoU) with the State Governments

The MoUs contain the following commitments by the State Government and the Reserve Bank.

The State Governments, through the MoU, agree to:

• Introduce long form audit report for statutory audit and modify their audit rating models to bring them in alignment with the gradation system adopted by the Reserve Bank for UCBs.

• Provide for statutory audit by Chartered Accountants (CAs) for UCBs with deposits over Rs.25 crore and special audit by CAs, if required by the Reserve Bank, for any UCB. • Put in place ‘fit and proper’ criteria for Chief Executive Officers (CEOs), based on guidelines of the Reserve Bank. The Reserve Bank, as a signatory to the MoU, is committed:

• To constitute a State Level Task Force for Urban Co-operative Banks (TAFCUB), comprising Regional Director of the Reserve Bank, Registrar of Co-operative Societies (RCS) of the State, a representative of Central Box IV.2: Memorandum of Understanding (MoU) with the State Governments Office of Urban Banks Department of the Reserve Bank, a representative of the State Government and a representative each from the State and National Federation of UCBs. TAFCUBs would identify and draw up time bound action plans for the revival of potentially viable UCBs and recommend non-disruptive exit for non-viable ones.

• To facilitate human resources development and IT initiatives in UCBs. MoUs signed between the Reserve Bank and the respective State Governments also envisage the signing of another MoU between the Registrars of Co-operative Societies of the States and respective Regional Directors of the Reserve Bank. This MoU stipulates the broad measures to be taken by the signatories for implementing the recommendations of the TAFCUB for each of the potentially viable/non-viable UCBs that are placed for consideration of AFCUB.

The MoU, inter alia, also provides that the Reserve Bank would consult RCS before canceling or refusing licence under the BR Act, 1949, of a UCB covered by the MoU, i.e., in States with which MoUs have been signed. The RCS would comply without delay any requisition by the Reserve Bank for supersession of the Board or for winding up of any UCB. stakeholders towards creation of a climate of stability that would, in turn, help in progressive restoration of public confidence in urban cooperative banking system.
With a view to encouraging and facilitating consolidation and emergence of strong entities and as well as for providing an avenue for non-disruptive exit of Weak/unviable entities in the co-operative banking sector, guidelines were issued to facilitate merger/amalgamation in the sector. The Reserve Bank, while considering proposals for merger/amalgamation, will confine its approval to the financial aspects of the merger taking into consideration the interests of depositors and financial stability. The Reserve Bank would consider proposals subject to the post-merger entity meeting the prescribed following prudential norms: When the net worth of the acquired bank is positive and Box IV.3: Mergers/Amalgamations for Urban Co-operative Banks the acquirer bank assures to protect entire deposits all the depositors of the acquired bank.

- When the net worth of acquired bank is negative but acquirer bank, on its own, assures to protect deposits all the depositors of the acquired bank.

- When the net worth of the acquired bank is negative and acquirer bank assures to protect the deposits of all depositors with financial support from the State Government extended upfront as part of the process of merger.

The Reserve Bank had conveyed its no objection to five merger proposals up to August 27, 2005.
2. **Objective**

- In the light of above, the broad objectives of the document can be set out as under: -

  i. To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector

  ii. To facilitate a focused and continuous system of supervision through enhanced use of technology.

  iii. To enhance professionalism and improve the quality of governance in UCBs by providing training for skill up-gradation as also by including large depositors in the decision making process / management of banks.

  iv. To put in place a mechanism that addresses the problems of dual control, given the present legal framework, and the time consuming process in bringing requisite legislative changes

  v. To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for their being nurtured back to health including, if necessary, through a process of consolidation

  vi. To identify the unviable entities in the sector and provide an exit path for such entities.

3. **The Operating Environment**

- Urban cooperative banks form a heterogeneous group in terms of geographical spread, area of operation, size or even in terms of individual performance. As such, development of the urban cooperative banking institutions into safe and vibrant entities requires the small banks in the group to be insulated from systemic shocks by emphasizing their
cooperative character. Further, the weak banks may have to be strengthened as a group, through a process of consolidation that may entail mergers/ amalgamations of viable entities and exit of the unviable ones, if there are no other options available. It is also felt that it is necessary to set up a supervisory system that is based on an in-depth analysis of the heterogeneous character of the urban cooperative banks and one that is in tandem with the policy of strengthening the sector.

4. **Regulatory Environment**

- The urban co-operative banks are regulated and supervised by State Registrars by of Co-Operative Societies, Central Registrar of Co-Operative Societies in case of Multi state cooperative banks and by Reserve Bank. The Registrars of Co operative Societies of the States exercise powers under the respective co-operative societies Act of the States in regard to incorporation, registration, management, amalgamation, reconstruction of liquidation. In case of the urban co-operative banks having multi-state presence, the central Registrar of Co-operative Societies, New Delhi, exercises such powers. The banking related functions, such as issue of license to start new banks / branches, matters relating to interest rates, loan policies, investments, prudential exposure norms etc. are regulated and supervised by the Reserve Bank of India under the provisions of the Banking Regulation Act, 1949 (AACS). Various Committees in the past, which went into working of the UCBs, have found that the multiplicity of command centers and the absence of clear-cut demarcation between the functions of State Governments and the Reserve Bank have been the most vexatious problems of urban cooperative banking movement. This duality of command is largely
responsible for most of the difficulties in implementing regulatory measures with the required speed and urgency and impedes effective supervision.

**Regulatory Initiatives for UCBs**

UCBs have grown rapidly since the early 1990s. During the phase of rapid expansion, however, the sector showed certain weaknesses arising out of lack of sound corporate governance, unethical lending, comparatively high level of loan defaults, inability to operate in a liberalised and competitive environment. The Reserve Bank, therefore, has been striving to harness the growth of UCBs with appropriate application of prudential regulation and supervision to safeguard the interests of depositors. The Reserve Bank initiated several regulatory measures during 2004-05 to ensure the growth of UCBs along sound lines.

**Regulation and Supervision of UCBs**

The Reserve Bank is entrusted with the responsibility of regulation and supervision of the banking related activities of primary co-operative banks under the Banking Regulation (B.R.) Act, 1949 As Applicable to Co-operative Societies (AACS). Other aspects such as incorporation, registration, administration, management and winding-up of UCBs are supervised and regulated by the respective State Governments through Registrars of Co-operative Societies (RCS) under the Co-operative Societies Acts of the respective States. UCBs with a multi state presence are registered under the Multi State Co-operative Societies Act, 2002 and are regulated and supervised
jointly by the Central Government through Central Registrar of Co-operative Societies and the Reserve Bank.

The current legislative framework provides for dual control over UCBs. For resolving problems arising out of dual control regime, a draft legislative bill proposing certain amendments to the Banking Regulation Act, 1949 (AACS), based on the recommendations of the High Powered Committee on UCBs, was forwarded to the Government. Pending the amendment to the Act, the Reserve Bank is entering into a regulatory arrangement with the State Governments through Memorandum of Understanding (MoU) to facilitate proper and coordinated regulation and supervision of UCBs. MoUs have already been signed between the Reserve Bank and three States that have a large network of UCBs, viz., Andhra Pradesh, Gujarat and Karnataka. As a follow-up to the signing of MoUs, the Reserve Bank has constituted TAFCUBs in these States (Box IV.2). Efforts are being made to enter into MoUs with other States having a large number of UCBs.

**Licensing of New Banks/Branches**

Consequent upon the easing of licensing norms in May 1993, more than 800 licenses were issued (up to June 2001) for setting up urban cooperative banks. However, close to one-third of these newly licensed UCBs became financially weak within a short period (Appendix Table IV.2 and Appendix Table IV.3). There was, thus, a need to moderate the pace of growth of this sector, particularly given the vexatious issue of dual control over UCBs. The Reserve Bank proposed certain amendments to the Banking Regulation Act, 1949 (AACS) to overcome the difficulties arising out of dual control. Pending enactment of these amendments, it was announced in the Annual Policy
Statement for 2004-05 that issuance of fresh licenses would be considered only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the urban cooperative banking sector is formulated. Accordingly, at present, applications for banking license, including license for opening of new branches, are not considered.

**Income Recognition, Asset Classification and Provisioning Norms**

In line with the international best practice and extant practices in commercial banks in India, it was decided to reduce the time period for reckoning an advance as non-performing from the existing 180 days to 90 days with effect from March 31, 2004. However, subsequently keeping in view the representations received from co-operative federations/banks, small loans up to Rs.1 lakh, including gold loans, were exempted from the purview of the 90 days norm and continue to be governed by 180 days norm. This exemption has been granted only up to March 31, 2006. It was also decided to grant additional time of two years, in comparison with commercial banks, to meet the 100 per cent provisioning required for advances identified as doubtful for more than three years.

Further, taking into consideration representations received from UCBs, it was decided to permit certain categories of UCBs to classify loan accounts as NPAs based on 180 days delinquency norm instead of 90 days norm. These included unit banks, *i.e.* banks having a single branch/HO and banks having multiple branches within a single district with deposits up to Rs.100 crore. The relaxation has been given up to the financial year ending March 2007 and banks
should build up adequate provisions to comply with the 90 days delinquency norm after the stipulated date.

It was decided to delink the asset classification and provisioning requirements in respect of State Government guaranteed advances and investments from the invocation of the State Government guarantee.

Accordingly, asset classification and provisioning norms on State Government guaranteed advances would be applicable in the same manner as exposures not guaranteed by the State Governments from the year ending March 31, 2006.

**Exposure Norms**

With a view to avoiding concentration of credit risk, UCBs were advised to fix the prudential exposure limits at 15 per cent and 40 per cent of the ‘capital funds’ in the case of a single borrower and a group of borrowers, respectively. Banks were also advised that ‘capital funds’ for the purpose of prudential exposure norms would be in relation to bank’s total capital funds (both Tier-I and Tier-II capital) and the exposure for the purpose includes both credit and investment exposure (non-SLR).

**Know Your Customer (KYC) Guidelines**

Know Your Customer (KYC) guidelines were revisited in the context of the recommendations made by the Financial Action Task Force (FATF) on Anti-Money Laundering (AML) standards and Combating Financing of Terrorism (CFT). Detailed guidelines based on the recommendations of the FATF and the paper on Customer Due Diligence (CDD) for banks by the Basel Committee on
Banking Supervision, with indicative suggestions wherever considered necessary, were issued to UCBs. They were advised to ensure that a proper policy framework on KYC and also AML measures is formulated and put in place with the approval of their Boards. Banks were also advised to ensure full compliance with the provisions of these guidelines before December 31, 2005.

**Investment Portfolios of UCBs - Relaxations**

UCBs were given some relaxation in the prudential norms for their investment portfolio in September 2004. They were allowed to exceed the limit of 25 per cent of total investment under ‘HTM’, held till maturity category provided (a) the excess comprises only SLR securities, and (b) total SLR securities held in ‘HTM’ category are not more than 25 per cent of their NDTL as on the last Friday of the second preceding fortnight. Taking into account the difficulties faced by UCBs in meeting the provisioning requirements, it was further decided, as a special case, to consider relaxing the provisioning requirements both for scheduled UCBs and nonscheduled UCBs. Accordingly, scheduled UCBs were advised that they may crystallise the provisioning requirement arising on account of shifting of securities from ‘HFT’/‘AFS’ categories to ‘HTM’ category consequent to the issue of guidelines dated September 2, 2004 and amortise the same over a maximum period of five years commencing from the accounting year ended March 31, 2005, with a minimum of 20 per cent of such amount each year.

As regards non-scheduled UCBs, they were allowed to shift securities from ‘HFT’/‘AFS’categories to ‘HTM’ category at book value, subject to the following conditions. First, in case the book value is higher than the face value, the difference between the book value and the face value, *i.e.*, the premium may
be amortised in equal instalment over the remaining period to maturity. If the security was obtained at a discount to face value, the difference should be booked as profit only at the time of maturity of the security.

Second, the securities transferred under this special dispensation should be kept separately under ‘HTM’ category and should not be transferred back to the ‘HFT’/’AFS’ category in future in terms of the existing instruction of transfer of securities from ‘HTM’ category.

Third, in normal course, such securities under ‘HTM’ category should not be sold in the market and redeemed on maturity only. However, in exceptional circumstances, if such securities are to be sold, profit on sale of investments in this category should be first taken to the ‘profit and loss account’ and thereafter be appropriated to the ‘capital reserve’. Loss on sale will be recognised in the ‘profit and loss’ account in the year of sale.

**Disclosure Norms**

In consonance with the best practices and in the interest of the members and depositors, it was decided that disclosure of the details of the levy of penalty on a bank would be put in public domain though a Press Release by the Reserve Bank. The UCBs were also advised that the penalty should be disclosed in the ‘Notes on Accounts’ to their balance sheets in their next Annual Reports.

With a view to indicating the exact status of co-operative banks as also to avoid confusion among members of public, all UCBs were advised to display their full name on stationery item, publicity material and name board in the form in
which it appears in the Certificate of Registration issued by the Registrar of Co-operative Societies and the licence granted by the Reserve Bank.

**Housing Loans under the Priority Sector**

In order to improve flow of credit to the housing sector, it was decided that UCBs with the approval of their Boards may extend direct finance to the housing sector up to Rs.15 lakh per beneficiary of a dwelling unit, irrespective of location, against the earlier limit of Rs.10 lakh, as part of their priority sector lending.
Implementing Governance in Urban Co-operative Banks

Urban Cooperative Banking is an important constituent of Multi-agency banking system operating in the country. These institutions play an important role in the economic upliftment of lower and middle-income group of persons. In recent years, the functioning of UCBs has come into sharp focus of the Government of India and the regulatory and supervisory authorities’ viz. Reserve Bank of India. The weaknesses which have crept into rise urban co-operative banking system, over the years, leading to failure of some of them, have posed systemic threat and shaken the confidence of the general public in the system. The problems faced by urban cooperative banks are mismanagement, financial impropriety and poor credit and investment decisions. The Reserve Bank of India is concerned with the deteriorating health of the system and is now focusing lb supervisory attention more closely for consolidation of the system.

Defining Governance

We are hearing day in and day out the need for corporate governance n every sphere of business and -, financial activities. Even the State Governments are talking of good governance. Corporate governance has become a buzzword in today’s context. There are various definitions of corporate governance by different proponents of this concept Let us try to understand the simple definition of Corporate Governance. In common parlance, corporate means any entity, which is legally binding as a united body and governance means direction, control and management. In other words, corporate governance means running the affairs of a corporate body by giving appropriate directions and with proper management and control. Banking institutions, which are,
legally constituted bodies under various statutes, are corporate bodies and they have to be run with proper management and control to ensure their profitability and financial viability.

**Pre-requisites of good Governance**

In any banking institution, whether it is a commercial bank or a Co-operative bank, its financial performance largely depends upon the efficient functioning of Board of management, chief executive officer, senior management, interest, shown by the operating staff and shareholders who constitute four pillars of the organization. Each of these entities has to act in unison for successful operations of the bank. Let us try to understand the role and responsibilities of each of these pillars in the effective governance of the organization).

**Depoliticisation of Co-operative banking system**

Proper governance in UCBs has not been possible due to political interference. In order to depoliticise the system, there should be legal prohibition on the MLAs/ MLCs / MPs and other political leaders holding office of profit in state I central public sector undertakings to become directors of co-operative banks.

RBI I NABARD should prevail Upon government of India / state government to bring suitable amendments to State Co-operative Societies Act / B. R. Act, 1949 (AACS).
1. Need for Cohesive Leadership

2. Formulation of loan and Investment Policy

3. Investment Policy

4. Business Strategy, Corporate Vision

5. Strengthening of credit appraisal and monitoring system

6. Delegation of Powers

7. Human Resources Development

8. Supervisory role of the Board

**Organisation’s Philosophy**

Every Unit of the Cooperative Credit and Banking Sector should adopt a philosophy as a tool for protecting the interest of its members and stakeholders with co-operative principles as the means for implementing the said philosophy. This section of the reporting should also spell out the Corporate objectives and goals to be achieved in the form of vision and mission statement.

**Adherence to Cooperative Principles Identity**

Cooperatives are distinct from corporate entities as they follow certain basic philosophy, principles and values like self-help, mutual help, democratic
management, one member one vote, universality of membership, faith in cooperative federalism, limited returns on capital, helping the, poor, collectivism, cooperative education, training and publicity, member-welfare, social obligation and service to community. This philosophy, principles and values should be upheld to maintain distinct identity of the cooperatives. How these have been practiced and realised should be stated clearly. Corporate Governance in cooperatives mean adhering to these principles and practice.

**Compliance with provision of Cooperative Law**

Cooperatives are governed by Cooperative Law and every cooperative is required to follow the law and rules framed there under in letter and spirit. Conducting business, maintaining accounts, audit of accounts, holding Board and AGM Meetings conduct of elections, etc. should be strictly as per law and bye-laws.

**Compliance with other Laws and ‘Regulations**

Besides cooperative laws there are also other laws like B.R. Act and RBI Act applicable to the Cooperatives which are to be complied with. RBI’s regulations like cash ratio & SLR and prudential norms, Asset liability management and risk management are other important areas which require effective oversight by the Management. These details should be given in the report and reflected in, the accounts in a transparent manner.
OTHER ISSUES

Prudential authorities are important stakeholders and play a significant role in corporate governance. To some extent, prudential supervision can compensate for deficiencies in the corporate governance mechanisms of banks. However, this risks creating a circular problem, in the sense that bank shareholders or members may rely on supervisors to monitor managers and become complacent about corporate governance issues, while supervisors increasingly rely on market discipline (exerted by a bank’s owners). The third pillar under Basel II formalizes this reliance on market discipline.

*Boards may have limited democratic legitimacy and be biased in favor of specific constituencies.*

Consistent with their democratic principles, boards in cooperatives are elected on a one-member/one-vote basis. This implies that, in mature and large cooperatives, members have few incentives to vote. Voting may require a degree of effort (e.g., physical presence at the annual meeting) that is disproportionate to the influence a single vote buys. The same problem affects small shareholders in commercial companies. However, large shareholders in commercial companies can aspire to having some influence and have more incentives to exert that influence. Small shareholders may free-ride on their efforts, calculating that the interests of all shareholders (maximization of shareholder value) are aligned anyway. In cooperatives, different constituencies of members have different interests, depending on the nature of their relationship with the cooperative.
Hence, although all members have an equal vote at the annual meeting, members with special or disproportionate interests in the policies of the cooperative have more incentives to put up the efforts needed to attend - and vote at—the annual meetings. Member-employees are one such special interest group. If employees tend to be disproportionately present at annual meetings, a cooperative bank may start to resemble a worker cooperative rather than a consumer cooperative. Large borrowers constitute another such interest group, raising the possibility that limited attendance at annual meetings may result in borrower interests weighing is proportionately on the cooperative’s policies. In small communities, local politicians can often use their connections and ability to influence large numbers of people to obtain disproportionate power in local cooperatives, turning them into semi-public financial institutions. Finally, there is a possibility that groups with specific ideological or other objectives may be overrepresented at annual meetings.

Member participation and attendance at annual meetings varies significantly, depending on the efforts undertaken by managers and boards. Many cooperative banks have vibrant member participation and well-attended annual meetings. This is especially the case for smaller cooperatives that are still closely connected to their base. However, there is also evidence that member participation in cooperatives (financial or other) is often very limited, with larger and older organizations tending to have lower participation levels. Find average member participation of two percent in the annual meetings of . According to representatives of the cooperative banking sector, typical participation rates for Indian cooperative banks are in the five to eight percent range, which implies large absolute numbers of participants.
It may be difficult for members to influence decisions at the annual meetings. Information asymmetries, procedures, and practical difficulties for members to organize themselves without the cooperation of management may make it difficult for them to challenge management. When applicable, proxy votes tend to be given overwhelmingly to the chairperson (Spear, 2004). As a result, uncontested board elections are often the norm. While similar problems exist in commercial companies, they are likely to be more daunting in cooperatives, in part because of the absence of large shareholders.

Adverse selection problems not only affect attendance at annual meetings, but also the (self-)selection of candidates for board membership. The factors that determine the incentives members face in deciding whether to attend the annual meeting also affect their incentives in deciding whether to volunteer for a position on the board. Moreover, just as in commercial companies, management often has the ability to propose candidates of their own choosing. In many cooperatives, members simply vote on a board composition that is proposed to them by management.

Lay board members may lack the ability to effectively supervise senior managers. Whereas board members in commercial companies tend to be selected from within the business community and thus have extensive business experience, knowledge, and networks, in cooperatives many board members are laypeople without the necessary background to effectively support and question management. As a result, boards tend to become passive receivers of information and the organization tends to become management driven. The increasingly complex activities cooperative banks are engaging in exacerbate this problem.
The cooperative may lack scope to pursue certain objectives through board member selection. The constraints on the selection of board members (who must typically come from within the membership) imply that cooperatives have less ability to use their boards as a tool to create external links with other organizations (Cornforth, 2004). In some cooperatives this effect is mitigated by the board’s ability to co-opt external members.

Management performance is harder to measure and monitor. Because cooperatives tend to pursue a diversity of goals and managers have to look after the interests of different constituencies, there is no simple quantitative gauge of management performance (such as profits) in cooperatives. As a result, boards may have difficulties accurately assessing and monitoring this performance.

Cooperatives, especially smaller ones, may have problems attracting sufficient managerial talent. Small cooperatives in which democratic processes work well and personal involvement of members is high may end up with crucial management jobs being undertaken by non-professionals. Cooperatives that hire professional managers may have difficulties attracting good quality managers if their remuneration policies do not allow them to pay market rates. The fact that cooperatives cannot offer stock-based compensation plans may be a handicap in this regard. Cooperatives frequently seek to overcome these challenges by offering training and education to managers, both as a means to raise the quality of management and as an incentive.

The market for corporate control cannot function in the case of cooperatives. The non-transferability of cooperative shares precludes the possibility of a hostile takeover bid and therefore the disciplining effect this possibility may exert. Joint-stock subsidiaries of cooperatives could in theory be subject to
hostile takeover bids, but in practice this possibility is typically precluded by the cooperative parent(s) holding a majority stake. However, Bechtel (2002) note that the market for corporate control often does not work and may in any case be undesirably disruptive. Adams and Mehran (2003) note that the market for corporate control rarely works for banks.

Block holders do not exist. In many countries, block holders are the dominant form of corporate governance arrangement in commercial companies. Blockholders are large shareholders, who have the resources, incentives and voting power to actively and continuously monitor managers. Small shareholders may choose to rely on these blockholders to defend the interest of all shareholders. However, blockholders are often primarily concerned with their own interests. If they pursue these interests at the expense of those of smaller shareholders, the governance challenge is simply transformed rather than resolved.

Delegated monitoring can work, but is often absent. Delegated monitoring refers to the monitoring of managerial performance by third parties such as institutional investors and large creditors. While there is no reason why this could not work for cooperatives, in practice there is often no abundance of potential delegated monitors (abstracting from prudential authorities, see above). Many cooperatives are highly liquid and therefore do not need to borrow from third parties, and the membership/investor base typically does not include institutional investors. On the other hand, as noted above, quite a few European cooperatives have sought financial market exposure and accepted the delegated monitoring that this implied.
Executive compensation contracts may be more difficult to bring in line with member interests. Executive compensation contracts that are designed to align managers’ interests with those of shareholders have long been used as a corporate governance mechanism in commercial enterprises, with results that have not always generated universal enthusiasm (for a critical assessment, see Bebchuck, Fried, and Walker, 2001).

For cooperatives, however, designing such contracts faces a number of difficulties. Stock-based compensation plans are generally not possible, and the cooperative ideals and culture are unlikely to tolerate monetary incentives at anything near the scale of what has become customary in the commercial sector. More fundamentally, the breadth, diversity and measurement challenges of “member interests” make the design of such contracts difficult.

Nonetheless, it should be possible to design compensation contracts that include variable compensation in function of managers’ success in realizing well-defined and measurable objectives considered crucial for the success of the cooperative.

Member lawsuits are unlikely to serve as a disciplining mechanism. The combination of clearly defined fiduciary duties and the threat of lawsuits to enforce them is an important governance mechanism in the US context (Becht et al., 2002), albeit one that is not without disadvantages and is of questionable net benefit to shareholders. However, it is generally less applicable in Europe and would have to overcome daunting collective action problems in the context of a cooperative. For a typical member, joining a lawsuit is not a cost-effective undertaking, given the limited financial investment that is at stake, the costs
involved, and the low expected value of any compensation that might be
granted. Only members with special interests may have sufficient incentives to
engage in a lawsuit, and in doing so they may not seek to let the general interest
of members prevail.

*Cost-benefit Perspective*

Another way of investigating corporate governance challenges is to look at the
incentives the different actors face. It should be particularly enlightening to
investigate what incentives principals face in their oversight of agents. This
section attempts to do so by looking at governance through the prism of a cost-
benefit analysis, as seen from the perspective of members.

Governance costs come in various forms. Hansmann (1996) identifies three
broad categories of ownership/governance costs: agency costs, which consist of
costs related to monitoring management and the costs of managerial
opportunism; costs of collective decision-making; and costs of risk-bearing. In
the long run, he argues that successful organizations are those that manage to
minimize these costs. The discussion below applies Hansmann’s conceptual
framework, but regroups the cost categories under two headings:
costs of making governance mechanisms work effectively (costs of monitoring
management and costs of collective decision-making) and costs that may
materialize when they do not work effectively (costs of managerial opportunism
and costs of risk-bearing). The discussion also explicitly considers some
negative costs (benefits).
**Costs and benefits related to effective governance mechanisms**

**Monitoring costs**

The dispersed ownership that characterizes cooperatives increases monitoring costs, thus reducing incentives for members to engage in effective monitoring. For a given level of effectiveness, monitoring costs increase due to duplication, as compared to commercial companies with more concentrated ownership. Moreover, because efforts by an individual owner have the character of a public good for others and because the effectiveness of an individual member’s efforts is likely to be very limited, it is rational for members of large cooperatives to refrain from undertaking thorough monitoring.

**Costs and benefits of collective decision-making**

Hansmann defines costs of collective decision-making as those that result from heterogeneity of interests among the owners. He identifies four forms:

- Costly decisions: are decisions that are inefficient in the sense of not maximizing the welfare of members as a group. In cooperatives, such inefficient decisions can arise because the median member, whose preferences tend to determine the outcome of a vote, has different preferences from the weighted average member (with the weights being the interest each member has in the decision). For example, in a cooperative in which 60 percent of members are depositors and 40 percent are borrowers, the depositors could systematically vote for policies that maximize their gains, rather than for policies that would maximize the combined gains of both depositors and borrowers. Costly decisions can also be the result of a minority
gaining control over the political process and pursuing its own interests rather than the interests of members as a group. As discussed above, this is a genuine risk in cooperatives, given the low incentives for members to get involved in their governance.

- Costly process: among the costs of the collective choice process, Hansmann identifies the time and effort required from owners to make decisions and the possibility of voting cycles. One could add to that the opportunity costs that may be generated by lengthy decision-making processes: business opportunities may be lost or problems that are damaging the firm or threatening its survival may be left unaddressed. In cooperatives, such costs may be substantial, especially when the annual meeting takes place only once per year. On the other hand, the costs of decision-making processes is contained to a significant extent by the degree to which powers are delegated to the board and management. In large networks of cooperatives, the situation for the network as a whole becomes more difficult and processes may be even more costly, though.

- Resolving conflicts: the resolution of conflicts among different (constituencies of) members can take a long time or even be impossible, unless there are very specific rules for doing so.

Benefits of participation: collective decision-making also has important benefits. In many situations, it can produce better and better informed decisions that will be implemented with more zeal by everyone involved. In cooperative banks, consumer participation in decision-making can be a great strength if it assures that the cooperative’s policies and products are kept in tune with the (perhaps rapidly evolving) needs of members. As discussed above, the
involvement of member-employees in decision-making also provides significant benefits.

**Costs that may materialize when governance is not effective**

**Costs of managerial opportunism**

The costs of managerial opportunism can come in various forms, some of which are especially relevant in cooperatives. In Hansmann’s conceptual framework, the costs of managerial opportunism are those that result from failure to monitor managers with perfect effectiveness. Such costs can range from outright theft to the foregone benefits that would have been possible with a more competent or harder working management team. While the risk of criminal prosecution is likely to put limits on managerial opportunism, a wide range of possibilities exist for managers to take advantage of their position without significant risk of prosecution. The nature of cooperatives, and in particular the existence of their owner-less endowment, renders a number of risks especially relevant:

- Managers could pursue interests other than the general interest of members. Such interests could be those of a particular constituency of members, public policy interests, or the interests of outside parties that are in one way or another connected to the managers. In hybrid groups, there is a risk that managers may favor the interests of listed subsidiaries of the group over those of the group as a whole and its membership.

- A growing endowment gives management the temptation and resources to engage in empire-building. Hansmann points out that one form of managerial opportunism is the risk of excessive retention of earnings, which is encouraged
by managers’ desire to retain or build their empire. As noted above, most cooperatives have a built-in tendency to retain the bulk of their earnings. Managers do not normally have an incentive to change this. Instead, they are more likely to seek to expand the cooperative’s business beyond what is in the best interest of members. In doing so, they may engage the cooperative into ventures that are undesirably risky from the membership’s point of view. The risks related to empire-building are discussed more in detail in the next section, on financial stability.

- Managers may seek, or fail to prevent, appropriation of (part of) the cooperative’s intergenerational endowment. Enjolras (2000) notes that the main source of inefficiency in non-profit organizations appears to stem from the private appropriation of collective resources by a minority of stakeholders. There are various ways in which managers can appropriate the collective resources of a cooperative, in particular (the fruits of) its intergenerational endowment. A particular risk in hybrid cooperative groups is that the endowment is put at the disproportionate disposal of outside investors. However, above all, there is a risk that managers may seek or support demutualization, regardless of whether this is in the best interest of members.

Costs and benefits of risk-bearing

Members of a cooperative typically bear little risk, which has upsides and downsides. Hansmann points out that the costs of ownership also include costs related to the right to residual earnings, in particular the costs of bearing risks associated with the enterprise. In this area, cooperatives are in a very particular situation, because these risks are borne in the first instance by the cooperative’s
intergenerational endowment. Members of cooperatives often also do not receive high rates of remuneration on their investment, as profits are in part added to the endowment. In sum, members do not face much risk—downside or upside—because of the buffer function provided by the endowment.

In some countries, members carry risks beyond their membership contribution. In Switzerland and Germany, members of cooperative banks are personally liable for losses, subject to a limit that exceeds the value of their member shares. It is not clear, though, that this liability can be called upon in practice.

**Balance of Governance Considerations**

On balance, the incentives for management to take advantage of governance weaknesses do not seem matched by incentives for members to make governance mechanisms work. With no ownership rights over the cooperative’s intergenerational endowment and low costs of risk-bearing, members face few incentives to undertake costly efforts to participate in governance mechanisms that are in many cases ineffective and characterized by a public-good nature. For managers, though, the presence of this endowment provides incentives to exploit corporate governance weaknesses in order to build empires or appropriate part of the endowment.

Competitive markets exert a disciplining effect on a cooperative but also reduce the incentives for members to participate in its governance. The more competitive a market is, the less consumer surplus there is likely to be gained from participating in the governance mechanisms of a cooperative. It is often simply much more cost-effective to go buy from the competition. Although
banking tends to be an oligopolistic market that is at times characterized by rather high profit margins, in many cases there is not enough to be gained for a member of a cooperative from seeking active involvement in its governance.

Governance challenges have led to the demise of quite a few cooperatives, although many others have prospered. The governance challenges discussed above have manifested themselves throughout the history of cooperative banks in Europe (see, for example, Pedelty, 1999). However, the success and longevity of many cooperative banks indicates clearly that these challenges are not insurmountable.

Even more than is the case for commercial organizations, the success or failure of cooperatives may depend on the people who run them. Many cooperatives are run by managers who genuinely want the best for their firm and derive satisfaction from generating benefits for members and employees. Such non-monetary drivers of motivation are usually not captured in theoretical models based on the assumption that people seek to maximize their own income/consumption. In this regard, Hansmann (1996) notes that pride and moral suasion provide important motivation to managers to work for the best interest of their firm, and that many organizations have thrived without (effective oversight by) owners. Given this, difficulties for owners to exercise direct control may “only result in a modest amount of organizational slack, at least when compared with any realistic alternative.” (2005)
Conclusions

In conclusion, it is essential that the cooperative banking sector adopts Cooperative Governance Practices on the lines of Corporate Governance’ Practices adopted by the corporate sector including commercial banks. While the corporate governance practices are legally binding on corporate, there is no such compulsion for cooperative banks today except that they have to follow the cooperative principles, cooperative and other laws and regulatory norms prescribed by RBI / NABARD, etc. Even these governance practices they follow are not reported and there is hardly any transparency. The management has to demonstrate its accountability and responsibility to the members and other stakeholders. Truthful and accurate disclosure in a transparent manner is the essence of corporate governance which the cooperative banking sector should follow voluntarily. This will contribute significantly to enhance the image and credibility of the sector.

Step for Strengthening Through Corporate Governance in Co-operative Banks In India:

- The literature on corporate governance in its wider connotation covers a range of issues such as protection of shareholders’ rights, enhancing shareholders’ value, Board issues including its composition and role, disclosure requirements, integrity of accounting practices, the control systems, in particular internal control systems. Corporate governance especially in the co-operative sector has come into sharp focus because more and more co-operative banks in India, both in urban and rural areas, have experienced grave problems in recent times which has in a way
threatened the profile and identity of the entire co-operative system. These problems include mismanagement, financial impropriety, poor investment decisions and the growing distance between members and their co-operative society.

- The purpose and objectives of cooperatives provide the framework for cooperative corporate governance. Co-operatives are organised groups of people and jointly managed and democratically controlled enterprises. They exist to serve their members and depositors and produce benefits for them. Co-operative corporate governance is therefore about ensuring co-operative relevance and performance by connecting members, management and the employees to the policy, strategy and decision-making processes.

- In fact, the very definition of corporate governance stems from its organic link with the entire gamut of activities having direct or indirect influence on the financial health of corporate entities. For the Nobel Prize-winning economist Milton Friedman, who was one of the first to attempt a definition, corporate governance is to conduct business in accordance with owner or shareholders’ desires which generally will be to make as much money as possible while conforming to the basic rules of the society embodied in law and local customs. In subsequent definitions, the scope of corporate governance has got expanded. While some experts say corporate governance means doing everything better, to improve relations between companies and their shareholders, to encourage people to think long-term, to ensure that information needs of all shareholders are met and to ensure that executive management is monitored properly in the interest of shareholders, the Former President
of World Bank, Mr. James Wolfensohn had said that corporate
governance is about promoting corporate fairness, transparency and
accountability. A more comprehensive definition has come from the
Organisation of Economic Co-operation and Development (OECD)
which identifies corporate governance as the system by which business
corporations are directed and controlled. Here the corporate governance
structure specifies the distribution of rights and responsibilities among
different participants in the corporation, such as the Board, managers,
shareholders and other stakeholders and spells out the rules and
procedures for making decisions on corporate affairs. By doing this, not
only does it provide the structure through which the company objectives
are set, it also provides the means of attaining these objectives and
monitoring performance.

- It will certainly not be out of place here to recount how issues relating to
corporate governance and corporate control have come to the fore the
world over in the recent past. The seeds of modern corporate governance
were probably sown by the Watergate scandal in the USA. Subsequent
investigations by US regulatory and legislative bodies highlighted control
failures that had allowed several major corporations to make illegal
political contributions and bribe government officials.

- While these developments in the US stimulated debate in the UK, a spate
of scandals and collapses in that country in the late 1980s and early 1990s
led shareholders and banks to worry about their investments. Several
companies in UK which saw explosive growth in earnings in the ’80s ended the
decade in a memorably disastrous manner. Importantly, such spectacular
corporate failures arose primarily out of poorly managed business practices.
This debate was driven partly by the subsequent enquiries into corporate governance (most notably the Cadbury Report) and partly by extensive changes in corporate structure. In May 1991, the London Stock Exchange set up a Committee under the Chairmanship of Sir Arian Cadbury to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them. The Committee investigated accountability of the Board of Directors to shareholders and to the society. It submitted its report and associated ‘code of best practices’ in December 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability. Being a pioneering report on corporate governance, it would perhaps be in order to make a brief reference to its recommendations which are in the nature of guidelines relating to, among other things, the Board of Directors and Reporting and Control.

The Cadbury Report stipulated that the Board of Directors should meet regularly, retain full and effective control over the company and monitor the executive management. There should be a clearly accepted division of responsibilities at the head of the company which will ensure balance of power and authority so that no individual has unfettered powers of decision. The Board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands. There should also be an agreed procedure for Directors in the furtherance of their duties to take independent professional advice.
On Reporting and Control, the Cadbury Report recommended that the Board should ensure that an objective and professional relationship is maintained with the auditors. It is the Board’s duty to present a balanced and understandable assessment of the company’s position, the report said. The Board should establish an Audit Committee with written terms of reference which deal clearly with its authority and duties. The Directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. The Directors should also report on the effectiveness of the company’s system of internal control. The report also stipulated that the Directors should report that the business is a going concern with supporting assumptions or qualifications as necessary.

The Cadbury Report generated a lot of interest in India. The issue of corporate governance was studied in depth and dealt with by the Confederation of Indian Industry (CII), Associated Chamber of Commerce and Industry (ASSOCHAM) and Securities and Exchange Board of India (SEBI). These studies reinforced the Cadbury Report’s focus on the crucial role of the Board and the need for it to observe a Code of Best Practices. Co-operative banks as corporate entities possess certain unique characteristics. Paradoxical as it may sound, evolution of co-operatives in India as peoples’ organisations rather than business enterprises adopting professional managerial systems has hindered growth of professionalism in cooperatives and proved to be a neglected area in their evolution.
Professionalism reflects the co-existence of high level of skills and standards in performing duties entrusted to an individual. The absence of a proper system of placement and skill upgradation inputs constrain professional management in co-operative banks. Though there is a system of training in place in many co-operative banks, attempts are seldom made to match them with the current and future staff requirements. It is desirable that the training programmes encompass skill upgradation and aptitude development in full measure. It is also necessary to keep the staff sufficiently motivated through periodic job rotation, job enrichment and recognition of performance. The co-operative banks should indeed work like professional organisations on sound managerial systems in tune with the needs of the time taking care of future projections of requirements to retain and improve their market share and identity in the long run. It is in this context that professionalism and accountability of the banks’ boards assume such critical significance.

Regulators are external pressure points for good corporate governance. Mere compliance with regulatory requirements is not however an ideal situation in itself. In fact, mere compliance with regulatory pressures is a minimum requirement of good corporate governance and what are required are internal pressures, peer pressures and market pressures to reach higher than minimum standards prescribed by regulatory agencies. RBI’s approach to regulation in recent times has some features that would enhance the need for and usefulness of good corporate governance in the co-operative sector. The transparency aspect has been emphasised by expanding the coverage of information and timeliness of such information and analytical content. Importantly, deregulation and operational freedom must go hand in hand with operational transparency.
In fact, the Reserve Bank Governor’s April 2002 Monetary and Credit Policy announcements have made it clear that with the abolition of minimum lending rates for co-operative banks, it will be incumbent on these banks to make the interest rates charged by them transparent and known to all customers. Banks have therefore been asked to publish the minimum and maximum interest rates charged by them and display this information in every branch. Disclosure and transparency are thus key pillars of a corporate governance framework because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of. We in the Reserve Bank see transparency and disclosure as an important adjunct to the supervisory process as they facilitate market discipline of banks.

Another area which requires focused attention is greater transparency in the balance sheets of co-operative banks. The commercial banks in India are now required to disclose accounting ratios relating to operating profit, return on assets, business per employee, NPAs, etc. as also maturity profile of loans, advances, investments, borrowings and deposits. The issue before us now is how to adapt similar disclosures suitably to be captured in the audit reports of co-operative banks. The Reserve Bank had advised Registrars of Co-operative Societies of the State Governments in 1996 that the balance sheet and profit & loss account should be prepared based on prudential norms introduced as a sequel to Financial Sector Reforms and that the statutory/departmental auditors of cooperative banks should look into the compliance with these norms. Auditors are therefore expected to be well-versed with all aspects of the new guidelines issued by the Reserve Bank and ensure that the profit & loss account and balance sheet of co-operative banks are prepared in a
transparent manner and reflect the true state of affairs. Auditors should also ensure that other necessary statutory provisions and appropriations out of profits are made as required in terms of Cooperative Societies Act/Rules of the state concerned and the bye-laws of the respective institutions.

- Appropriate internal control systems become even more critical in the context of the growing emphasis on diversification of business products as the prime need at all levels in co-operative credit institutions. It is indeed necessary for co-operative banks to devote adequate attention to maximising their returns on every unit of resources through an effective funds management strategy and mechanism. One prime component of the investment portfolio of the co-operative banks which has attracted a lot of attention - unfortunately for all the wrong reasons - is their transaction in government securities. So much so that it has even triggered the holding of today’s Convention.

- The financial sector reforms in India have sought to achieve, among other things, improvement in the financial health and competitive capabilities by means of prescription of prudential norms. The cooperative banks have also thus been put under the prudential norms regime to bring about the desirable level of transparency in their balance sheets. While urban co-operative banks (UCBs) have been subjected to income recognition, asset classification, provisioning and other related norms in a phased manner beginning April 1992, these prudential norms including asset classification and provisioning (excluding the capital adequacy ratio) were made applicable to the State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) from the year 1996-97 and
extended to Agriculture and Rural Development Banks (ARDBs) from 1997-98.

- The Reserve Bank had also issued comprehensive guidelines transactions in securities to all co-operative banks - both urban and rural - as early as in September 1992. Detailed guidelines have been given therein on transactions through brokers, Subsidiary General Ledger (SGL) facility, issue of Bankers Receipts, internal control systems, audit and review systems, etc. As per the guidelines in force, each bank is required to formulate an investment policy, with the approval of its Board. Banks have been advised that all transactions in Government Securities for which SGL facility is available should be put through SGL accounts only. Certain discipline has also been introduced for transactions through SGL accounts for minimising settlement risks through a framework for penal action against bouncing of SGL transfer forms for want of sufficient balance in the SGL account or current account.

- Banks were advised that only brokers registered with National Stock Exchange (NSE) or Bombay Stock Exchange (BSE) or Over the Counter Exchange of India (OTCEI) should be utilised for acting as intermediary. If the deal is put through a broker, the role of the broker should be restricted to that of bringing the two parties to the transaction together. The settlement of the transaction, namely, both funds settlement and security settlement should be made directly between the counter parties. With a view to ensuring that a disproportionate volume of transactions is not routed through one or a few broker, a prudential ceiling of 5 per cent of the total transactions (both purchases and sales) has been prescribed for routing transactions through an individual broker. In case any bank is
required to exceed the prudential ceiling of 5 per cent for any broker, the bank is required to inform the Board indicating the reasons therefor post-facto. Banks have also been advised to have proper internal control measures for monitoring the transactions in government securities.

- Regulatory policy can however only set the broad contours of an appropriate investment strategy. It is no guarantee for articulation and implementation of commercially sound investment decisions by lending institution(s). Even the most comprehensive regulatory framework and effective supervisory system need not be a foolproof mechanism against a pliant management acting in collusion with unscrupulous clients. Supervision is only periodic and therefore it cannot be a substitute for effective and continuous internal control backed by an independent and efficacious audit system. Towards this, it is imperative to have in place Audit Committees of the Board independent of the management in cooperative banks. It may well be recalled that with the extension of the Banking Regulations (BR) Act to the UCBs in 1966 and deposit insurance in 1971, people’s confidence in the co-operative sector had taken a big leap forward. So much so that today the non-member deposits in urban banks far exceed member deposits. Nothing would be more tragic if we fritter away these advantages and allow indiscipline and lack of commitment in these banks make people’s trust in the cooperative sector a casualty.

- One important issue that has engaged much attention in the recent past is the duality of control over co-operative banks. In terms of the Cooperative Societies Acts of respective States, the Registrar of Cooperative Societies was the sole regulator and supervisor of all the
societies registered in his State including societies carrying on banking business. With the application of BR Act, 1949 (AACS) to cooperative banks, this position has since changed. While the Reserve Bank now regulates and supervises banking activities carried on by urban co-operative societies, supervision of State Co-operative Banks and District Central Co-operative Banks is carried out by National Bank for Agriculture and Rural Development (NABARD). The core principles of supervision in relation to co-operative banks have thus to be formulated and implemented by the Reserve Bank in respect of UCBs and by NABARD in respect of SCBs and DCCBs and there is an emergent need to constantly beef up the supervisory system through proper on-site monitoring and adequate off-site surveillance. We also need to analyse and pick up early warning signals, if any, in respect of any such irregularities in the investment portfolio of these banks from the periodic review reports on such transactions which are received from them. There is also an urgent need for clarity in defining the roles of various control institutions by streamlining processes, procedures, etc. for removing overlapping of controls over cooperative banks presently vested with State Governments, the Reserve Bank and NABARD, as the may be. It is in this context that the Governor’s Monetary and Credit Policy announcement in April 2001 had stressed the need for a separate regulatory agency for the co-operative banks. This issue is being debated in various quarters.

- Credit institutions are linked to each other through a complex chain of inter-bank relationships which - as recent instances have showed - in any event of difficulty become mechanisms for spread of the contagion effect. Signs of financial mismanagement in an institution or a group of
institutions regardless of the reasons is liable to set off similar problems in other institutions and open serious risks in the financial system. It is in this context that good corporate governance assumes critical importance. Power and decision-making in co-operative banks are all too often concentrated at the top in too few hands. Cooperative performance has therefore been for a long time characterised by lack of participation and sense of involvement. Active members who feel that they are part of an organisation that has goals in harmony with their own and clear roles for constructively engaged, competent governing bodies and management would be a powerful force to build co-operative identity and excellence. It is perhaps time that the State Governments refashioned management in co-operative banks by picking up threads of good corporate governance.

- Success of economic decisions depends after all on the human resources at the disposal of any organisation. A change is needed today in the co-operative banks which is built on confidence in human capital - the most important of all resources - in commitment, creativity and innovation brought about by proactive management, membership and employees. Strong corporate governance that takes its obligations seriously can truly be a source of strength to the management. The ability to capture knowledge and wisdom gives co-operative banks their competitive advantage. A prerequisite is that participants from all parts of a co-operative organisation know and understand its purpose, core values and visions.

- In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and financial markets acquire greater depth. The real success
of our financial sector reforms will however depend primarily on the organisational effectiveness of the banks, including co-operative banks, for which initiatives will have to come from the banks themselves. It is for the co-operative banks themselves to build on the synergy inherent in the co-operative structure and stand up for their unique qualities. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business areas like micro finance, commitment to better customer service, adequate mechanisation and proactive policies on house-keeping issues, co-operative banks will definitely be able to grapple with these challenges and convert them into opportunities.
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