CHAPTER-I

1. Corporate Governance – An Introduction

1.1 Introduction

The subject of corporate governance has attracted worldwide attention with a series of collapse of high profile companies like Enron, WorldCom, HIH insurance group etc. These failures have shattered the trust of investors worldwide. Some of the scandals which made headlines all around the world were somewhere related to poor corporate governance. These include the $18 billion meltdown of Parmalat Finanziaria, in 2003. Parmalat was among the largest food-based companies in the world. The Parmalat case was one of the biggest scandals to hit Europe and many analysts called this fraud as 'Europe's Enron'. The company's corporate governance structure could not keep up to some of the key existing Italian corporate governance standards of best practice (Melis, 2004). Another classic example of a corporate house collapsing due to poor decision making and weak corporate governance was the HIH insurance group of Australia. This collapse resulted in a deficiency up to $5.3 billion, “making it the largest corporate failure” in Australia (Lipton, 2003). The collapse of the China Aviation Oil (CAO) also created certain doubts regarding the standard of corporate governance in China. This collapse came at a time when many companies were trying to get internationally listed and foreign investors were becoming more and more eager to buy them out (Economist Intelligence Unit, 2004). Poor corporate governance in banks is not a new subject. This inefficiency has been around for a very long time. Since the beginning of banking in
Nigeria in 1914, almost 75 banks were lost primarily because of factors related to poor corporate governance. The banks did not fail due to lack of customers but due to how they were managed and governed. According to a study by the Nigerian Deposit Insurance Corporation, the main reason for these failures was interference of board members (www.allafrica.com). Moreover, the recent subprime crises highlighted many issues of corporate governance in banks world over. The main issue was that of independent directors. For e.g., UBS, one of the world’s largest banks was among the biggest losers in the subprime crisis. It suffered a loss of about $38 billion. As a result it replaced four of its directors. The departing members included “three outsiders with experience respectively in rail equipment, chemicals and information technology”. This shows that banks should definitely use experts on their boards (Economic Times, 2008). According to Zabihollah Rezaee (2005), there may be seven reasons behind these high profile failings. These include lax regulations, overconfident and egoistic management, and inappropriate business conduct by top level management, deficiency of alert oversight functions, unproductive audit functions, poor financial disclosures and negligent shareholders. The above frauds adversely affect corporate governance, auditors’ creditability and the quality of financial statements. A good thing that came out of these corporate scandals was the global acceptance of the need for necessary checks and balances. Worldwide, it has now become necessary for big corporate houses to address the issue of corporate governance as investor demands fluctuate. Responsibility, transparency, fairness and accountability are the four vital pillars for strong corporate governance. Large and trusted companies across the globe realized the significance of corporate governance and subsequently took drastic steps to ensure practice of corporate
governance. These days corporate governance is a reality which can’t be overlooked by any financial institution who wants to be successful. There are a number of factors which force a company to adhere to a set of corporate governance principles. These may include stern regulators, vigilant and smart investing community, alert customers and the awareness among companies to be good corporate citizens. Companies should ensure a constant flow of profits but without crossing moral and ethical boundaries. However, some bad experiences in the past have exposed the fact that big corporate houses which have committed frauds have tacit support from banks. Questions have arisen thick and fast as to how people entrusted with governance of these corporate/banks, had failed to detect and stem the rot, before it was too late. Banks are constituted as companies under the companies act and they should be concerned with good governance Corporate governance has always been closely monitored by Asian regulators and this term has been a top priority for them in recent times. This is happening because of the fact that most of the markets have introduced a wide range of regulations. This particular research will try to unfold the cause and effect of governance principles on banks. This research also studies the effectiveness of its so-called objectives to control them is governance in Indian Corporate sector. Next, this research analyses the upcoming evidence on which government policies improve the governance of banks and describes tentative guidelines for future modification of its principles. Corporate Governance is aimed at ensuring proper governance of business as well as complying with all the governance norms prescribed by regulatory board for the benefit of all interested parties including society. The basic objective is the maximization of long-term shareholders value within the parameter of public law and social ethics to give an impression to customers and
employees about the transparency and fairness of business. Particularly in banking sector, good corporate governance is very much essential for justifying its role in money management. Best practices of corporate governance in banks are of great value to a number of stakeholders’ viz., depositors, creditors, customers, shareholders, employees and society at large. Corporate governance is about the nitty-gritty of how a corporation executes its commitment to investors and other stakeholders. It is about loyalty to investors, valuing principled business behavior and functioning with a high degree of transparency. The corporate governance is therefore a systematic approach where the connective members, management and employees are expected to cooperate in the decision making process of the company. Based on some fundamental reasons, the corporate governance holds its premise that the business should be conducted by the desires of shareholders. It identifies the distribution of rights and responsibilities among a variety of stakeholders in the company. It also briefly outlines the structure and process for judgment on matters related to the company dealings. In the context of the above, the following are the broad objectives on which corporate governance can be measured: i) Suggested model code of best practices, ii) Preferred internal systems, iii) Recommended disclosure requirements, iv) Board members’ role, v) Independent director, vi) Key information to the board/committee, vii) Committees of board, viii) Policies to be established by the board and ix) Monitoring performance. (Buxi, 2005) Effective corporate governance is important for any company to be successful irrespective of the type of business it does. But for banks and financial institutions corporate governance assumes a greater level of importance. There may be a couple of reasons for this; firstly, banks form a very vital connection in the financial system which helps to mobilize and
allot funds between borrowers and depositors. Efficient banks help create healthy economies as they are the back bone of any financial system. “If the saga of various financial crises across the world is any indication, the banks have been the precipitators of crises”. Secondly, banks are morally responsible for the funds which they move within an economy as they are the keepers of the money of their depositors. This forces the government to help them out when they are in trouble. In contrast to companies in other sectors, corporate governance in the Indian Banking sector has very different implications. The banking sector in India is subject to stricter guidelines and parameters. Further, it also makes banking a highly regulated industry, when the “State keeps close to its heart”. (ICFAI Journal, 2001). As per Basel committee Report 1999, Banks have to display the exemplary of corporate governance practices in their financial performance, transparency in the balance sheets and compliance with other norms laid down by section 49 of corporate governance rules. Most importantly, their annual report should disclose accounting ratios, relating to operating profit, return on assets, business per employee, NPAs, maturity profile of loans, advances, investments, borrowings and deposits. Similarly the audit reports of bank should highlight those disclosures which are in line with corporate governance rules. Hence, auditors should have the complete know how about all the features of the latest guidelines given by Reserve Bank of India (RBI) and ensure that the financial statements are made in a fraud free manner and should mirror the implementation of corporate governance. Apart from auditor’s seriousness to bring those requirements appropriately in audit report, there should be adequate internal control systems in the operational activities of banks. It is very much essential for banks to devote adequate attention on internal control system so as to maximize their returns on
each unit of capital inducted through an effective funds management strategy and mechanism. (Basel Committee Report, 1999) Corporate governance has, of course, been an important subject of discussion since many years. Scholars and researchers from finance fields have actively investigated the importance and efficacy of corporate governance for at least a quarter of century (Jenson and Meckling, 1976). There have been intense brainstorming and debates over the practices of corporate governance practices particularly in the developed nations. However, the effectiveness of corporate governance practices in the developed nations tells an ironical story from the CG (corporate governance) practices point of view. The volume of scandals and lack of transparency in governance in the developed nations nullifies its true commitment to governance practices compared to the developing world (Shleifer et al., 1997). Therefore, much prior to the recent wave of corporate frauds in developed economies, corporate governance has been a fundamental subject in emerging economies.

1.2 Definition of corporate Governance

The term ‘Corporate Governance’ which was rarely encountered before the 1990s has now become an all-pervasive term in the recent decade. In today’s scenario this term has become one of the most crucial and important concepts in the management of companies. The root of Corporate governance dates back to Adam Smith but its popularity is of recent origin. The concept of corporate governance can be understood as the system through which shareholders are assured that their interest will be taken care of by management. In a much wider term, corporate governance was defined 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 (Parekh, 2003). The literature on corporate governance in its wide subtext covers a variety of aspects, such as protection of shareholder’s rights, improving shareholders value, board matters etc.

However, the importance of corporate governance in banking sector weighs very much due to very nature of banking transactions. Banking is the crucial factor effecting economic development of an economy. It is the life-blood of a country. It is responsible for the flow of credit and for maintaining the financial balances of the economy. In India, since the nationalization process banks emerged as a tool of economic development along with social justice. Corporate Governance has become very important for banks to perform and remain in competition in this era of liberalization and globalization.

**Corporate Governance: In Search of a Definition**

The term governance has been derived from the word gubernare, which means to rule or steer. Originally this term meant to be a normative framework for exercise of power and acceptance of accountability used in the running of kingdoms, regions and towns. However, over the years it has found significant relevance in the corporate world. This is basically due to growing number and size of the corporations, the widening base of the shareholders, increasing linkages with the physical environment, and overall impact on the society’s wellbeing as we need a proper administrative system to regulate so many complex things. The analysis of World Bank definition on corporate governance seems more appropriate as it analyzes from two different perspectives. From the company's point of view, the stress is put on the relations between the various stakeholders such as owners,
management, employees, customers, suppliers, investors and communities. From another perspective in defining corporate governance is reliable path where the corporate governance structures can be established. So, a “nation’s system of corporate governance can be seen as an institutional matrix that structures the relations among owners, boards, and top managers, and determines the goals pursued by the corporation”. (World Bank, 2002) The OECDs (1999) original definition is: “Corporate governance 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, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

According to Economist and Noble Laureate Milton Friedman, “Corporate Governance is to conduct the business in accordance with owners or shareholders’ desires, while conforming to the basic rules of the society embodied in law and local customs”(Economic Times, 2001). In nutshell, it can be said that corporate governance means doing everything better to improve relationships between companies and their shareholders, to improve quality of outside directors, to encourage people to think long-term and to ensure that information needs of all stakeholders are met. The discussion on governance has been dated back more than decade in different economies. Traveling through the pre-1992 American discussions on disassociation of power and money (emanating from the Watergate Scandal), post-1992 Cadbury Report on governance codes and OECD principles (1998 & 1999), corporate governance has not yet settled at any universally accepted definition.
Let us now discuss some of the important definitions of Corporate Governance.

1. “Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on the investment.” *The Journal of Finance, Shleifer and Vishny, 1997* (page 737)

2. “Corporate Governance is about promoting corporate fairness, transparency and accountability.” *J.Wolfenson, President of the World Bank as quoted by an article in Financial Times June 21, 1999*

3. “Corporate Governance – which can be defined narrowly as the relationship of a company to its shareholders, or, more broadly, as its relationship to society …” *Financial Times 1997*

4. “Corporate Governance is the system by which business corporations are directed and controlled. 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, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.” *OECD April 1999 (OECD’s definition is consistent with the one presented by Cadbury, 1992)*

5. “Corporate Governance is a field in economics that investigates how corporations can be made more efficient by the use of institutional structures such as contracts, organizational designs and legislation. This is often limited to the question of shareholder value i.e. how the corporate owners can motivate and/or secure that the corporate managers will deliver a competitive rate of return. *Mathiesen (1999)*
1.3 Concept of Corporate governance

Corporate Governance may be defined as a set of systems, processes and principles which ensure that a company is governed in the best interest of all stakeholders. It is the system by which companies are directed and controlled. It is about promoting corporate fairness, transparency and accountability. In other words, 'good corporate governance' is simply 'good business'. It ensures:

- Adequate disclosures and effective decision making to achieve corporate objectives;
- Transparency in business transactions;
- Statutory and legal compliances;
- Protection of shareholder interests
- Commitment to values and ethical conduct of business

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 systems 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.

In other words, corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. In this regard, the management needs to prevent asymmetry of benefits
between various sections of shareholders, especially between the owner-managers and the rest of the shareholders.

It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company. Ethical dilemmas arise from conflicting interests of the parties involved. In this regard, managers make decisions based on a set of principles influenced by the values, context and culture of the organization. Ethical leadership is good for business as the organization is seen to conduct its business in line with the expectations of all stakeholders.

The aim of "Good Corporate Governance" is to ensure commitment of the board in managing the company in a transparent manner for maximizing long-term value of the company for its shareholders and all other partners. It integrates all the participants involved in a process, which is economic, and at the same time social.

Nowhere is proper corporate governance more crucial than for banks and financial institutions. Given the pivotal role that banks play in the financial and economic system of a developing country, bank failure owing to unethical or incompetent management action poses a threat not just to the shareholders but to the depositing public and the economy at large. Two main features set banks apart from other business – the level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities.

The opaqueness in banking creates considerable information asymmetries between the "insiders" – management – and "outsiders" – owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of
banks as well as siphon off funds. It is, therefore, much more difficult for the owners to effectively monitor the functioning of bank management. Existence of explicit or implicit deposit insurance also reduces the interest of depositors in monitoring bank management activities.

It is partly for these reasons that prudential norms of banking and close monitoring by the central bank of commercial bank activities are essential for smooth functioning of the banking sector. Government control or monitoring of banks, on the other hand, brings in its wake, the possibility of corruption and diversion of credit of political purposes which may, in the long run, jeopardize the financial health of the bank as well as the economy itself.

The reforms have marked a shift from hands-on government control interference to market forces as the dominant paradigm of corporate governance in Indian banks. Competition has been encouraged with the issue of licenses to new private banks and more power and flexibility have been granted to the bank management both in directing credit as well as in setting prices. The RBI has moved to a model of governance by prudential norms rather from that of direct interference, even allowing debate about appropriateness of specific regulations among banks. Along with these changes, market institutions have been strengthened by government with attempts to infuse greater transparency and liquidity in markets for government securities and other asset markets. This market orientation of governance disciplining in banking has been accompanied by a stronger disclosure norms and stress on periodic RBI surveillance.

From 1994, the Board for Financial Supervision (BFS) inspects and monitors banks using the “CAMELS” (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach.
Audit committees in banks have been stipulated since 1995. Greater independence of public sector banks has also been a key feature of their forms. Nominee directors – from government as well as RBIs – are being gradually phased off with a stress on Boards being more often elected than “appointed from above”. There is increasing emphasis on greater professional representation on bank boards with the expectation that the boards will have the authority and competence to properly manage the banks within the broad prudential norms set by RBI. Rules like non lending to companies who have one or more of a bank’s directors on their boards are being softened or removed altogether, thus allowing for “related party” transactions for banks. The need for professional advice in the election of executive directors is increasingly realized.

As for old private banks, concentrated ownership remains a widespread characteristic, limiting the possibilities of professional excellence and opening the possibility of misdirecting credit.

1.4 Objectives of Corporate Governance

The fundamental objective of corporate governance is to enhance shareholders' value and protect the interests of other stakeholders by improving the corporate performance and accountability. Hence it harmonizes the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company. Further, its objective is to generate an environment of trust and confidence amongst those having competing and conflicting interests.
It is integral to the very existence of a company and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. Broadly, it seeks to achieve the following objectives:

- A properly structured board capable of taking independent and objective decisions is in place at the helm of affairs;
- The board is balance as regards the representation of adequate number of non-executive and independent directors who will take care of their interests and well-being of all the stakeholders;
- The board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information;
- The board has an effective machinery to subserve the concerns of stakeholders;
- The board keeps the shareholders informed of relevant developments impacting the company;
- The board effectively and regularly monitors the functioning of the management team;
- The board remains in effective control of the affairs of the company at all times.

The overall endeavor of the board should be to take the organization forward so as to maximize long term value and shareholders' wealth.
1.5 Prerequisites and Constituents

Today adoption of good Corporate Governance practices has emerged as an integral element for doing business. It is not only a pre-requisite for facing intense competition for sustainable growth in the emerging global market scenario but is also an embodiment of the parameters of fairness, accountability, disclosures and transparency to maximize value for the stakeholders.

Corporate governance is beyond the realm of law. It cannot be regulated by legislation alone. Legislation can only lay down a common framework – the "form" to ensure standards. The "substance" will ultimately determine the credibility and integrity of the process. Substance is inexorably linked to the mindset and ethical standards of management.

Studies of corporate governance practices across several countries conducted by the Asian Development Bank, International Monetary Fund, Organization for Economic Cooperation and Development and the World Bank reveal that there is no single model of good corporate governance.

The OECD Code also recognizes that different legal systems, institutional frameworks and traditions across countries have led to the development of a range of different approaches to corporate governance. However, a high degree of priority has been placed on the interests of shareholders, who place their trust in corporations to use their investment funds wisely and effectively is common to all good corporate governance regimes.

Also, irrespective of the model, there are three different forms of corporate responsibilities
which all models do respect:

- **Political Responsibilities**: the basic political obligations are abiding by legitimate law; respect for the system of rights and the principles of constitutional state.

- **Social Responsibilities**: the corporate ethical responsibilities, which the company understands and promotes either as a community with shared values or as a part of larger community with shared values.

- **Economic Responsibilities**: acting in accordance with the logic of competitive markets to earn profits on the basis of innovation and respect for the rights/democracy of the shareholders which can be expressed in terms of managements' obligation as 'maximizing shareholders value'.

In addition, business ethics and corporate awareness of the environmental and societal interest of the communities, within which they operate, can have an impact on the reputation and long-term performance of corporations.

The three key constituents of corporate governance are the Board of Directors, the Shareholders and the Management.

- The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in the company in a
transparent manner to all the stakeholders.

- The shareholders' role in corporate governance is to appoint the directors and the auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information in a transparent fashion, of the activities and progress of the company.

- The responsibility of the management is to undertake the management of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board to monitor the accountability of management to it.

The underlying principles of corporate governance revolve around three basic inter-related segments. These are:

- Integrity and Fairness
- Transparency and Disclosures
- Accountability and Responsibility

The Main Constituents of Good Corporate Governance are:

- **Role and powers of Board**: the foremost requirement of good corporate governance is the clear identification of powers, roles, responsibilities and accountability of the Board, CEO and the Chairman of the board.

- **Legislation**: a clear and unambiguous legislative and regulatory framework is fundamental to effective corporate governance.
- **Code of Conduct**: it is essential that an organization's explicitly prescribed code of conduct is communicated to all stakeholders and is clearly understood by them. There should be some system in place to periodically measure and evaluate the adherence to such code of conduct by each member of the organization.

- **Board Independence**: an independent board is essential for sound corporate governance. It means that the board is capable of assessing the performance of managers with an objective perspective. Hence, the majority of board members should be independent of both the management team and any commercial dealings with the company. Such independence ensures the effectiveness of the board in supervising the activities of management as well as make sure that there are no actual or perceived conflicts of interests.

- **Board Skills**: in order to be able to undertake its functions effectively, the board must possess the necessary blend of qualities, skills, knowledge and experience so as to make quality contribution. It includes operational or technical expertise, financial skills, legal skills as well as knowledge of government and regulatory requirements.

- **Management Environment**: includes setting up of clear objectives and appropriate ethical framework, establishing due processes, providing for transparency and clear enunciation of responsibility and accountability, implementing sound business planning, encouraging business risk assessment, having right people and right skill for jobs, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures and evaluating performance and sufficiently recognizing individual and group contribution.
- **Board Appointments**: to ensure that the most competent people are appointed in the board, the board positions must be filled through the process of extensive search. A well-defined and open procedure must be in place for reappointments as well as for appointment of new directors.

- **Board Induction and Training**: is essential to ensure that directors remain abreast of all development, which are or may impact corporate governance and other related issues.

- **Board Meetings**: are the forums for board decision making. These meetings enable directors to discharge their responsibilities. The effectiveness of board meetings is dependent on carefully planned agendas and providing relevant papers and materials to directors sufficiently prior to board meetings.

- **Strategy Setting**: the objective of the company must be clearly documented in a long term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.

- **Business and Community Obligations**: though the basic activity of a business entity is inherently commercial yet it must also take care of community's obligations. The stakeholders must be informed about the approval by the proposed and ongoing initiatives taken to meet the community obligations.

- **Financial and Operational Reporting**: the board requires comprehensive, regular, reliable, timely, correct and relevant information in a form and of a quality that is appropriate to discharge its function of monitoring corporate performance.

- **Monitoring the Board Performance**: the board must monitor and evaluate its combined performance and also that of individual directors at periodic intervals,
using key performance indicators besides peer review.

- **Audit Committee**: is inter alia responsible for liaison with management, internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the board on the key issues.

- **Risk Management**: risk is an important element of corporate functioning and governance. There should be a clearly established process of identifying, analyzing and treating risks, which could prevent the company from effectively achieving its objectives. The board has the ultimate responsibility for identifying major risks to the organization, setting acceptable levels of risks and ensuring that senior management takes steps to detect, monitor and control these risks.

A good corporate governance recognizes the diverse interests of shareholders, lenders, employees, government, etc. The new concept of governance to bring about quality corporate governance is not only a necessity to serve the divergent corporate interests, but also is a key requirement in the best interests of the corporate themselves and the economy.
1.6 Organizational Framework

The organizational framework for corporate governance initiatives in India consists of the Ministry of Corporate Affairs (MCA), the Confederation of Indian Industry (CII) and the Securities and Exchange Board of India (SEBI). In 1998, the Confederation of Indian Industry (CII), "India's premier business association," unveiled India's first code of corporate governance. However, since the Code's adoption was voluntary, few firms embraced it.

The first formal regulatory framework for listed companies specifically for corporate governance was established by the SEBI in February 2000, following the recommendations of Kumar Mangalam Birla Committee Report. It was enshrined as Clause 49 of the Listing Agreement (annexure 1).

Thereafter SEBI had set up another committee under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49, and suggest measures to improve corporate governance standards. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.
The Ministry of Corporate Affairs had also appointed a Naresh Chandra Committee on Corporate Audit and Governance in 2002 in order to examine various corporate governance issues. It made recommendations in two key aspects of corporate governance: financial and non-financial disclosures and independent auditing and board oversight of management.

It had also set up a National Foundation for Corporate Governance (NFCG) in association with the CII, ICAI and ICSI as a not-for-profit trust to provide a platform to deliberate on issues relating to good corporate governance, to sensitize corporate leaders on the importance of good corporate governance practices as well as to facilitate exchange of experiences and ideas amongst corporate leaders, policy makers, regulators, law enforcing agencies and non-government organizations.
FRAMEWORK OF CORPORATE GOVERNANCE

Corporate Governance Framework

Organizational Framework

Legal Framework

Ministry of Corporate affairs (MCA)

SEBI*

Confederation of Indian Industry (CII) Recommendations (1997-98)

Companies Act, 1956

Company Laws

SEBI Laws

Companies Bill, 2004

Section 292A (Setting up an Audit Committee)

Kumar Manglam Birla Committee Report (2000-01) (Listing Agreement) Clause 49


Naresh Chandra Committee Report on Corporate Audit and Governance 2002

National Foundation for Corporate Governance (NFCG) (association with CII, ICAI, ICSI)

Securities Contracts (Regulation) Act, 1956

SEBI ACT, 1992

Deposi Act, 19

* Securities Exchange Board of India.
The foundation has been set up with the mission to:

1. Foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders;

2. Create a framework of best practices, structure, processes and ethics; and

3. Make significant difference to Indian corporate sector by raising the standard of corporate governance in India towards achieving stability and growth.

1.7 Legal Framework

An effective regulatory and legal framework is indispensable for the proper and sustained growth of the company. In rapidly changing national and global business environment, it has become necessary that regulation of corporate entities is in tune with the emerging economic trends, encourage good corporate governance and enable protection of the interests of the investors and other stakeholders. Further, due to continuous increase in the complexities of business operation, the forms of corporate organizations are constantly changing. As a result, there is a need for the law to take into account the requirements of different kinds of companies that may exist and seek to provide common principles to which all kinds of companies may refer while devising their corporate governance structure.

The important legislations for regulating the entire corporate structure and for dealing with various aspects of governance in companies are Companies Act, 1956 and Companies Bill, 2004. These laws have been introduced and amended, from time to time, to bring more transparency and accountability in the provisions of corporate governance. That is,
corporate laws have been simplified so that they are amenable to clear interpretation and provide a framework that would facilitate faster economic growth.

Secondly, the Securities Contracts (Regulation) Act, 1956, Securities and Exchange Board of India Act, 1992 and Depositories Act, 1996 have been introduced by Securities and Exchange Board of India, with a view to protect the interests of investors in the securities markets as well as to maintain the standards of corporate governance in the country.

An effective legal framework is indispensable for the proper and sustained growth of the company. In rapidly changing national and global business environment, it has become necessary that regulation of corporate entities is in tune with the emerging economic trends, encourage good corporate governance and enable protection of the interests of the investors and other stakeholders. The Legal framework for corporate governance consists of the Company Laws and the SEBI Laws.

Company Laws:

The Ministry of Corporate Affairs (MCA) is the main authority for regulating and promoting efficient, transparent and accountable form of corporate governance in the Indian corporate sector. The important legislations governed by MCA for regulating the entire corporate structure and for dealing with various aspects of governance in companies are Companies Act, 1956 and Companies Bill, 2004. These laws have been introduced and amended, from time to time, to bring more transparency and accountability in the provisions of corporate governance. That is, corporate laws have been simplified so that they are amenable to clear interpretation and provide a framework that would facilitate faster economic growth.
The Companies Act, 1956:

It is the central legislation in India that empowers the Central Government to regulate the formation, financing, functioning and winding up of companies. The Companies Act, 1956 has elaborate provisions relating to the Governance of Companies, which deals with management and administration of companies. It contains special provisions with respect to the accounts and audit, directors remuneration, other financial and non-financial disclosures, corporate democracy, prevention of mismanagement, etc. The main two Sections of this Act related to the corporate governance are Section 292A and Section 211.

Section 292A:

The concept of Corporate Governance receives statutory recognition, with the insertion of Section 292A in the Companies Act, 1956 with an amendment made to it through the Companies (Amendment) Act 2000. The New Section 292A made it obligatory upon a public company having a paid-up capital of Rs. 5 crores or more to have an audit committee comprising at least three directors as members. Two-thirds of the total number shall be non-executive directors.

Section 211:

As per this Section, every Profit and loss account and Balance sheet of the company shall comply with the Accounting Standards, issued by the Institute of Chartered Accountants of India as may be prescribed by the Central Government in consultation with National Advisory Committee on Accounting Standards, and the Statutory auditors of every
company are required to report whether the Accounting Standards have been complied with or not. The Securities Exchange Board of India (SEBI) has added a new clause in the Listing Agreement to provide that listed enterprises shall compulsory comply with all the Accounting Standards issued by ICAI from time to time.

The Companies Bill 2004:
It has been introduced to provide the comprehensive review of the company law. It contained important provisions relating to corporate governance, like, independence of auditors, relationship of auditors with the management of company, independent directors with a view to improve the corporate governance practices in the corporate sector. It is subjected to greater flexibility and self-regulation by companies, better financial and non-financial disclosures, more efficient enforcement of law, etc. This amendment to the Companies Act 1956 mainly focused on reforming the audit process and the board of directors. It mainly aimed at :- (i) laying down the process of appointment and qualification of auditors, (ii) prohibiting non-audit services by the auditors; (iii) prescribing compulsory rotation, at least of the Audit Partner; (iv)requiring certification of annual audited accounts by both CEO and CFO; etc. For reforming the boards, the bill included that remuneration of non-executive directors can be fixed only by shareholders and must be disclosed. A limit on the amount which can be paid would also be laid down. It is also envisaged that the directors should be imparted suitable training. However, among others, an independent director should not have substantial pecuniary interest in the company’s shares.

SEBI Laws:
Improved corporate governance is the key objective of the regulatory framework in the
securities market. Accordingly, Securities and Exchange Board of India (SEBI) has made several efforts with a view to evaluate the adequacy of existing corporate governance practices in the country and further improve these practices. It is implementing and maintaining the standards of corporate governance through the use of its legal and regulatory framework, namely, The Securities Contracts (Regulation) Act, 1956, Securities and Exchange Board of India Act, 1992 and the Depositories Act, 1996.

1.8 Benefits and Limitations of Corporate Governance

The concept of corporate governance has been attracting public attention for quite some time. It has been finding wide acceptance for its relevance and importance to the industry and economy. It contributes not only to the efficiency of a business enterprise, but also, to the growth and progress of a country's economy. Progressively, firms have voluntarily put in place systems of good corporate governance for the following reasons:

- Several studies in India and abroad have indicated that markets and investors take notice of well managed companies and respond positively to them. Such companies have a system of good corporate governance in place, which allows sufficient freedom to the board and management to take decisions towards the progress of their companies and to innovate, while remaining within the framework of effective accountability.

- In today's globalised world, corporations need to access global pools of capital as well as attract and retain the best human capital from various parts of the world.
Under such a scenario, unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.

- The credibility offered by good corporate governance procedures also helps maintain the confidence of investors – both foreign and domestic – to attract more long-term capital. This will ultimately induce more stable sources of financing.
- A corporation is a congregation of various stakeholders, like customers, employees, investors, vendor partners, government and society. Its growth requires the cooperation of all the stakeholders. Hence it imperative for a corporation to be fair and transparent to all its stakeholders in all its transactions by adhering to the best corporate governance practices.
- Good Corporate Governance standards add considerable value to the operational performance of a company by:

  1. improving strategic thinking at the top through induction of independent directors who bring in experience and new ideas;
  2. rationalizing the management and constant monitoring of risk that a firm faces globally;
  3. limiting the liability of top management and directors by carefully articulating the decision making process;
  4. Assuring the integrity of financial reports, etc.

It also has a long term reputational effects among key stakeholders, both internally and externally.

- Also, the instances of financial crisis have brought the subject of corporate
governance to the surface. They have shifted the emphasis on compliance with substance, rather than form, and brought to sharper focus the need for intellectual honesty and integrity. This is because financial and non-financial disclosures made by any firm are only as good and honest as the people behind them.

- Good governance system, demonstrated by adoption of good corporate governance practices, builds confidence amongst stakeholders as well as prospective stakeholders. Investors are willing to pay higher prices to the corporate demonstrating strict adherence to internally accepted norms of corporate governance.

- Effective governance reduces perceived risks, consequently reduces cost of capital and enables board of directors to take quick and better decisions which ultimately improves bottom line of the corporate.

- Adoption of good corporate governance practices provides long term sustenance and strengthens stakeholders’ relationship.

- A good corporate citizen becomes an icon and enjoys a position of respects.

- Potential stakeholders aspire to enter into relationships with enterprises whose governance credentials are exemplary.

- Adoption of good corporate governance practices provides stability and growth to the enterprise.

Effectiveness of corporate governance system cannot merely be legislated by law neither can any system of corporate governance be static. As competition increases, the environment in which firms operate also changes and in such a dynamic environment the
systems of corporate governance also need to evolve. Failure to implement good governance procedures has a cost in terms of a significant risk premium when competing for scarce capital in today’s public markets.

Corporate governance in a developing country setting takes on additional importance. Good corporate governance is vital because of its role in attracting foreign investment. The extent of foreign investment, in turn, shapes the prospects for economic growth for many developing countries. Generally developing countries that have good corporate governance’s structures consistently outperform developing countries with poor corporate governance structures. Moreover, corporate governance can play a role in reducing corruption, and decreased corruption significantly enhances a country’s development prospects. Ultimately, the concept of corporate governance is not just one of those imported western luxuries; it is a vital consideration to be enforced successfully.

The aim of "Good Corporate Governance" is to ensure commitment of the board in managing the company in a transparent manner for maximizing long-term value of the company for its shareholders and all other partners. It integrates all the participants involved in a process, which is economic, and at the same time social. The fundamental objective of corporate governance is to enhance shareholders' value and protect the interests of other stakeholders by improving the corporate performance and accountability. Hence it harmonizes the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company. Further, its objective is to generate an environment of trust and confidence amongst those having competing and conflicting interests. There is a global consensus about the objective of ‘good’ corporate
governance: maximizing long term shareholder value. Since shareholders are residual claimants, this objective follows from a premise that, in well performing capital market, whatever maximizes shareholder value must necessarily maximize corporate prosperity, and best satisfy the claims of creditors, employees, customers, shareholders and the State.

Tests of Corporate Governance

Broadly, the test of corporate governance should cover the following aspects:

• Whether the funds of the company have been deployed for pursuing the main objects of the company as enshrined in the Memorandum?

• Whether the funds acquired from financial institutions and the capital market have been utilized for the purpose for which they were intended?

• Whether the company has the core competence to effectively manage its diversifications?

• Whether there has been proper diversion of funds by way of loans and advances or investments to subsidiary?

• Whether the provisions of the Companies Act, the Foreign Exchange Management Act, the Factories Act and other statutes are complied with in letter and in spirit?

• Whether the practices adopted by the company and its Management towards its shareholders, customers, suppliers, employees and the society at large are ethical and fair?

• Whether the directors are provided with the information on the working of the company and whether the institutional and non-executive directors play an active role in the functioning of the companies?

• Whether the internal controls in place are effective?

• Whether there is transparent financial reporting and audit practices and the accounting practices adopted by the company are in accordance with Accounting Standards of ICAI.
Limitations of corporate governance implementation in India

- If the Board is in awe of the family executive, it makes it difficult for the Board sometimes to ask tough questions or at other times the right questions at the right time in order to serve the interests of the shareholders better. As a result truly independent directors are rarely found in Indian companies. Serving on multiple boards is problematic because doing so can overburden directors, thus hampering their performance, and increase the potential for directors to experience conflicts of interest between the various corporations they serve.

- It is admitted that contribution of the independent directors is limited because the average time spent in Board meetings by these directors is barely 14 to 16 hours in a year. In some cases, it has been found that no proper training and orientation regarding the awareness of rights, responsibilities, duties and liabilities of the directors is provided to an individual before appointing him/her as a director in the Board. Also there is unseen but the active participation of political class.

- The directors on the board are largely reliant on information from the management and auditors, with their capacity to independently verify financial information being quite limited, while auditors, as this case suggests, have also been equally reliant on management information. The relevant issue here is the extent and the depth of auditors’ effort in their exercise of due diligence. Excessive reliance on information from the management is symptomatic of the ownership or control of companies in India by business families, and that poses a particular challenge for corporate governance in India.
• The greatest drawback of financial disclosures in India is the absence of detailed reporting on related party transactions, poor quality of consolidated accounting and segment reporting leads to misrepresentation of the true picture of a business group.

• Although India's investor-protection laws are sophisticated, litigants must wait a long time before receiving a judgment. Delays in the delivery of verdicts, high costs of litigation and the lengthy judicial appointment process in courts make the legal enforcement mechanism ineffective. According to the OECD, “the credibility and utility of a corporate governance framework rest on its enforceability.”

• In India, the two audit-related issues which are commonly recognized are that of auditor independence and the perceived powerlessness of auditors in the face of corporate pressure. In many cases, they are ill-equipped to handle the needs of large companies, because in the face of an audit failure, it is very difficult to discern whether the auditors were complacent or they were pressurized by the concerted efforts of the insiders.

• There is no proper system to monitor the work of audit firms or to review the accounts prepared by the company’s statutory auditors. However, in the aftermath of the Satyam case, the SEBI has decided to introduce a peer review mechanism to review the accounts prepared by a company’s statutory auditor. In addition, the SEBI has also decided to constitute a panel of auditors to review the financial statement of all BSE Sensex and NSE Nifty companies.

• Also there is no statutory compliance for the companies to obtain a report on Corporate Governance Rating by the Credit Rating Agencies in India.
1.9 Need of Corporate governance

Before going into corporate governance of banks in particular, let us recall, just for the sake of context, why corporate governance is important in general. At its most basic level, corporate governance sets up the “rules of the game” to deal with issues arising from separation of ownership and management so that the interests of all stakeholders are protected. Empirical evidence shows that businesses with superior governance practices generate bigger profits, higher returns on equity and larger dividend yields. Importantly, good corporate governance also shows up in such soft areas as employee motivation, work culture, corporate value system and corporate image. Conversely, the failure of high profile companies such as BCCI, Enron, WorldCom and Parmalat was a clear lesson of the damage bad corporate governance can inflict.

Here at home we had a corporate scandal of unprecedented dimensions in Satyam Computers where the company’s CEO admitted to having falsified accounts to the tune of over 7000 crore, and that too spread over several years. Even as the judicial process relating to this alleged fraud is still under way, the big question is in what ways was this a failure of corporate governance and how are we fixing those lacunae? We had instances of poor governance in the banking sector as well - erosion of standards in forex derivative transactions and fraud in wealth management schemes - reminding us that we need to work hard to get to best practice in every area 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 organization and the larger economy.

Secondly, it makes the resources flow to those sectors or entities where there is efficient production of goods and services and the return is adequate enough to satisfy the demands of stakeholders.

Thirdly, it provides abroad 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 pressurizes the organization 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 1.1: Dimensional significance of CG for corporations as well as for the economy

<table>
<thead>
<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>
</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>
</tr>
</tbody>
</table>

Source: Dufey (2003)

When institutions in any economy are it public or private, mismanage 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. Table-1.1 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.

As we are marching forward towards global economy, there are many economic issues coming up in the process for developing, emerging and transitional economies. These can be correctly identified as structural changes in market institutions. It brought about much awareness among investors, bankers and public at large. Such economy faced a retarded growth in spite of having economic reform like privatization, liberalization and lifting licensing raj. Despite flow of money in such economy, the growth could not take its stand due to unbalanced approach. The holder of para-state institutions such as privatization funds remain in the hands of largest shareholders of companies. As a result, the de facto power remains loaded in the hands of few individuals considered as internal owners, while the external owners do not have enough power to control the companies and thereby can’t ensure themselves to get appropriate returns (Fernando, 2002).

Another important factor in banking industry in developing countries is that banks are mostly owned by government. In such situation, banks are mostly guided by government bodies and many laws based on stereotype procedures. The accountability idea is less apparent as the concept of government job discourages the spirit of competition. The need for corporate governance in developing, emerging and transitional economies not only arises from resolving problems of ownership and control, but also from ensuring transparency in achieving the desired goal of corporate governance. In many cases,
developing and emerging economies are beset with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing.

Ownership pattern, regulatory environment, societal pressure (on the developmental role of banks) and the broad structure would be the key elements in the design of a governance framework of banking. While government ownership does provide core strength to banks, the structural inefficiencies and lack of management autonomy appears to have weakened the ability of banks (Public sector) to compete effectively in the current market situation (Ravisankar, 1999).

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

In order to overcome the under noted serious concerns within the business community, there is a need to introduce a system of corporate governance that will ensure the transparency, integrity and accountability of Management including non-executive directors.
• Concentration of greater financial power and authority in a lesser number of individuals,
• Violations of foreign exchange rules and regulations,
• Large scale diversion of funds to associate companies and risky ventures,
• Unfocussed business decisions leading to losses,
• Preferential allotment of shares to promoters at low prices,
• Exploited the weaknesses in the Accounting Standards to inflate profits and understate liabilities,
• Frequent changes in Board structures,
• Spinning off profitable business operations to subsidiary companies, and
• Charging of royalty for use of brand name by the parent company by leading companies.

In an open financial market, investors choose from a variety of investment vehicles. The existence of a corporate governance system is likely a part of this decision-making process. In such a scenario, companies that are more open and transparent, and thus well governed, are more likely to raise capital successfully because investors will have the information and confidence necessary for them to lend funds directly to such companies. Moreover, well-governed companies likely will obtain capital more cheaply than companies that have poor corporate governance practices because investors will require a smaller “risk premium” for investing in well-governed companies. Thus, in an efficient capital market, investors will invest in companies with better corporate governance frameworks because of the lower risks and the likelihood of higher returns. Good
corporate governance practices also enable Management to allocate resources more efficiently, which increases the likelihood that investors will obtain a higher rate of return on their investment.

Moreover, Good corporate governance practices ensure:

- Adequate disclosures and effective decision making to achieve corporate objectives;
- Transparency in business transactions;
- Statutory and legal compliances;
- Protection of shareholder interests;
- Commitment to values and ethical conduct of business.
- Long-term survival of the companies.
REFERENCES


