RELEVANCE OF CORPORATE GOVERNANCE IN BANKING

The ongoing reforms in the financial sector in the Country have brought into sharp focus the concept of corporate governance. Corporate governance has attracted worldwide\(^1\) attention in recent times. Even in the United States of America, a highly regulated and disciplined society, many giant companies such as Enron, World Com etc. have failed because of reported gross mismanagement, coupled with fraud committed by the top management\(^2\). Questions have arisen thick and fast as to how people entrusted with governance of these corporates, not to speak of the statutory auditors, had failed to detect and stem the rot, before it was too late. Though the discipline imposed by market may not be pleasant, better disclosure and transparency boosts the confidence in the business\(^3\).

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\(^3\) *Ibid.*
Banks have a unique place within the financial systems. Banks are constituted as companies under the Companies Act and they should also be concerned with good governance. Many committees have addressed this issue over the years and notable among them are Kumar Mangalam committee\(^4\) and Ganguly Committee\(^5\). The first committee examined the corporates in general and the second committee focused on banks and financial institutions. Although the two committees had set out detailed guidelines to ensure good governance many issues still continue unresolved. Depositor protection and public policy considerations have brought banks within comprehensive regulatory and supervisory framework all over the world. Besides, banks also enjoy safety nets in the form of deposit insurance and lender of last resort from the Central Bank of the Country\(^6\).

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\(^4\) Report of the Committee appointed by the SEBI on corporate governance under the Chairmanship of Sri. Kumara Mangalam Birla (1999).

\(^5\) Consultative group of Directors of Banks and Financial Institutions under the Chairmanship of Dr. A.S. Ganguli (2002), RBI.

**Meaning of Corporate Governance**

Corporates are entities authorized by law and society to conduct chosen business activity for a purpose, basically to earn profits\(^7\). Governance reflects the degree of control exercised by corporates over their decisions through organizational structures, laid down procedures and code of conduct and ethics towards attaining the purposes\(^8\). The former is an end and the latter the means to that end. The means may be likened to a seed, the end to a tree and there is just the same inviolable connection between the means and the end as there is between the seed and the tree\(^9\).

Corporates are owned by a large number of shareholders. Since it is impossible for these owners to directly manage or even supervise these corporates, they appoint their representatives as Board of Directors. The Board appoints the top management who in turn appoint other Managers and employees. In the actual management of the company, the Board takes one may say a ‘helicopter’ view but is expected to correct any wrong practices or actions of the management. To quote Kumar Mangalam Committee\(^10\) - “The

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\(^7\) See ‘OECD Principles of Corporate Governance’ dt.21\(^{\text{st}}\) June 1999.

\(^8\) Ibid.


\(^10\) *Supra* p.276.
pivotal role in any system of corporate governance is performed by the Board of Directors. It is accountable to the shareholders 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 a transparent manner to the stakeholders”.

Corporate governance\textsuperscript{11} has been defined as “the system by which organizations are directed and controlled”. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as Board, Management, shareholders and spells out the rules and procedures for making decisions on corporate affairs\textsuperscript{12}. By doing this, it also provides the structure through which the company’s objectives are set and the means of attaining those objectives and monitoring performance. The term ‘Corporate Governance’ is not well defined. There is a need to interpret corporate governance as widely as possible.

\begin{flushleft}
\textsuperscript{11} Corporate Governance: What it means and what is needs, Management Review (1996), December.
\end{flushleft}
Evolution of Corporate Governance

The emergence of large corporations during the middle and later part of the 20th Century brought in distinctive categories of stakeholders in the company in contrast with the earlier system of owners managing the company. While shareholders contributed the capital, the managers were changed with the responsibility of running the show to achieve the set goals of the corporation. Customers also started receiving due importance as their loyalty to and patronage of the company was crucial for its prosperity. In doing this, human resources were essential and the employees too gained prominence as stakeholders. With the realization of the concept of corporate citizen, responsibility to the society also became a relevant issue. When different categories of stakeholders came to be identified, it became necessary to take care of one another's interests. It was also necessary to harmonize the divergent interests so that the corporation could endure pressures of any single group. A code of practice that could be adopted in running the affairs of the company came to be evolved. These practices did not have necessarily a


14 Ibid.
legal sanction but the compulsion of managing a large corporate facilitated the evolution of what came to be recognized as best practices.

According to the organization for Economic Corporation and Development\textsuperscript{15} corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. These principles codified in 1999 were earlier highlighted by the Cadbury Committee\textsuperscript{16}. The company’s registered in the list of Stock Exchanges, were required to report the extent of their compliance with the Cadbury code in their annual reports. The thrust of Cadbury committee was on openness, integrity and accountability. In the Indian context Kumara Mangalam Birla Committee appointed by the SEBI\textsuperscript{17} formed the basis for corporate governance practices adopted by SEBI in 1999. As per SEBI’s directive all companies were required to include a clause on corporate governance in the listing agreement. Accordingly, certain actions and disclosures are now mandatory.

\textsuperscript{15} OECD, Principles of Corporate Governance (1998).

\textsuperscript{16} A Committee chaired by Sir Adrian Cadbury was set up by the London Stock Exchange in 1992 to examine the financial aspects of board functioning in the corporate sector. This Committee advocated a Code of Best Practice in its report popularly known as Cadbury Report.

\textsuperscript{17} Supra, n.4.
Objectives and ingredients of Corporate Governance

The definition given by O.E.C.D.\textsuperscript{18} contains the essential ingredients of corporate governance. The following issues are relevant.

1. It provides the structure through which the objectives of the company are set.
2. It prescribes the means of attaining those objectives.
3. It determines the method of monitoring the performance.

To further quote the O.E.C.D.\textsuperscript{19} paper 'good corporate governance' should provide proper incentives to the board and management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring thereby encouraging firms to use resources more efficiently. If the objectives of the company are to be achieved, there should be appropriate checks and controls, division of responsibility and disclosure and transparency\textsuperscript{20}.

\textsuperscript{18} Ibid.

\textsuperscript{19} Ibid.

\textsuperscript{20} A Survey of Management: Why honesty is the best policy?, March 9 (2002)
Kumar Mangalam Committee\textsuperscript{21} was clear that "the fundamental objective of corporate governance is the enhancement of shareholder value, keeping in view the interests of other stakeholders. As Management Guru, Peter Drucker\textsuperscript{22} stated way back in 1992 "for most people maximizing shareholder value means a higher share price between 6 months and 9 years – certainly not much longer. Such short term capital gains are the wrong objective for both the enterprise and its dominant shareholders. Recent corporate failures\textsuperscript{23} in U.S.A. have brought out clearly how prescient the guru was. Many Managers manipulated the profits of the companies to show illusory profits and thereby enhance market value of the shares. When the fraud came to light, all stakeholders, including the employees of the companies, suffered grievously. Therefore, enhancing shareholders value for the short term cannot be the prime objective of governance.


\textsuperscript{22} Peter F.Drucker, \textit{Managing for the Future – The 1990's and Beyond} (1992), p.73.

\textsuperscript{23} Giant companies such as Enron, Worldcom, etc. in U.S.A. failed due to gross mismanagement and fraud committed by the top management. The energy trading giant collapsed overnight and declared the biggest bankruptcy in the history of corporate America. People lost jobs and lifetime savings, economic value worth billions of dollars stood eroded. \textit{Infra}, p.303.
Protecting the interests of one kind of creditors, namely, depositors should be one of the primary objectives of banks. In other corporates, this is not and need not be so, for two reasons. First the depositors collectively entrust a very large sum to the cadre of banks. Secondly the depositors are very large in number and they do not generally have a direct say in the management of banks. In other corporates, lenders stake might not on an overall basis exceed 2 or 3 times the owner’s stake. Further some of the big lenders to other corporates would retain the right to direct the management. The total deposits of all scheduled banks as on March 31, 2001 was Rs.10.55 lakh crores\(^2\) as against the total net worth of Rs.68,000 crores. Thus depositors contribution was well over 15.5 times the shareholders’ stake\(^2\).\(^5\)

Regulators the world over have recognized the vulnerability of the depositors to the whims of managerial misadventures in banks and therefore have been regulating banks more tightly than other corporates\(^2\).\(^6\). The question that can be raised here is should the depositors have any direct role in governance of banks ?. For this purpose it is necessary to study the relevance

\(^2\) Report on Trend and Progress of Banking in India 2000-01, RBI.

\(^5\) Ibid.

of corporate governance in banking. When public ownership of banks makes
the system answerable to the political institution can corporate governance and
public sector banking be compatible?

Corporate Governance: Relevance to Banking

Banks are endowed with enormous financial resources belonging to
the public. The efficient deployment of these resources is critical to the
economy. Therefore the depositors and the economy jointly assume the
position of stakeholders in a bank. Considering the criticality of manpower in
a service industry, employees too become stakeholders. In case of PSB’s, the
Government and in case of banks in the private sector, the shareholders are the
other stakeholders. The interests of all these groups could be addressed
through corporate governance.

Experience of various countries with regard to bank failures has
clearly identified inadequate and inefficient management as one of the
principal factors. Bank supervisors therefore see one of their key tasks as

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28 Ibid.
29 Bank for International Settlements (1999), Enhancing Corporate Governance for Banking
Organisations, Sep.(1999).
enhancement of quality of corporate governance in bank management. The quality of corporate governance determines the efficiency of banking operation. Though it is a subject of paramount importance little significance is attached to it in respect of governance of bank. It is time that a code of governance\textsuperscript{30} be evolved for India banking which could set broad parameters of guidelines for operations. The first issue is that of enhancing corporate governance in banks. Secondly the approach of the RBI to regulation has some features that would enhance the need and use for good corporate governance in the banking sector\textsuperscript{31}.

\textit{Basel Committee's}\textsuperscript{32} Proposal

With reference to banks managed by the boards and the top management, the Basel committee on banking supervision laid down the following five specific tasks in the governance of banks:-

\begin{itemize}
  \item Basel Committee (1994). The G-10 Countries, namely, France, Germany, Belgium, Canada, Sweden, Switzerland, Italy, Japan, the United Kingdom and the United States formed a standing committee under the auspices of the Bank for International Settlements called the Basel Committee on banking supervision. The Committee comprises representatives from Central Banks and regulatory authorities.
\end{itemize}
a) Setting corporate objectives;

b) Running the day to day operations of the business;

c) Considering the interests of the recognized stakeholders;

d) Aligning corporate activities and behaviours with expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations; and

e) Protecting the interests of the depositors.

**Major issues of corporate governance in Indian PSB's**

In India, the structure of PSB's is such that the Government ownership provides them a safe wall; Government being the controlling shareholder, wields special influence on the governance of these banks\textsuperscript{33}. For example, it appoints almost all the directors, including the C.E.O. Even after the likely reduction in Government stake from 51% to 35% in all PSB's it is indicated that the Government will retain the powers to appoint the Chairman and Board of Directors\textsuperscript{34}. The objective of the government as the major shareholder of the PSB's has been to balance the constraints imposed by its accountability to Parliament on behalf of these institutions against the need to


\textsuperscript{34} Report in Financial Express, Mumbai, dated 5\textsuperscript{th} March (2000).
ensure effective management. Therefore the central forms of good corporate governance in Indian PSB's is protection of the rights of the minority shareholders. Therefore the achievement of good corporate governance means strengthening the regulation and supervision in this regard and providing strength to the Boards of the individual PSB's.35

*Corporate Values in the Present Banking Systems*

The present system of governance followed by Indian banks in general and PSB's in particular needs to be summarized before evaluating the effectiveness of such governance in relation to the principles commended by the Basel Committee.37

Banks have been under the constant oversight of RBI and the Ministry of Finance. Banking division, Government of India in formulating various banking policies. The periodic meetings the senior RBI functionaries and the Minister of Finance and his officials have with the C.E.O's of banks are used to review, advise and guide the banks on almost all matters regarding the working of the banks.

37 *Supra*, p.286.
With the increasing focus on the quality of administration after the serious scams$^{38}$, from 1992 onwards, every bank management today lays great emphasis on promoting value systems. The mission statements of many banks bear testimony to this awareness. For eg. one mission of Corporation Bank is “to emerge as a role model with distinct identity, ethical values and good corporate governance$^{39}$”. A system is also in place to communicate the objectives and values throughout the bank so that the employees imbibe them.

*Responsibility and Accountability*

Over years, considerable work has been done by banks to streamline the administration and professionalise it. Expert advice is sought to evaluate the extant lines of control and responsibility and improvements made. SBI taking the help of Mekensey & Co. is a classic example of such effort$^{40}$. Organisational structure is periodically recast to respond to new challenges and the ethics of responsibility from corporate to the ground level are laid down. The laid down code and principles, enshrined upon the Board of the banks to


$^{40}$ *Ibid.*
create and protect and enhance shareholder value, be fully accountable to the shareholders and report performance in a timely and transparent manner. But as things stand, the boards are neither accountable to the organization nor to the supervisors. Accountability often begins and ends with trying to fix responsibility when loans go bad\textsuperscript{41}.

\textit{Composition of board}

As of now, the appointments to the Boards of the banks require the approval of the regulator as per the B.R.Act, 1949 and Bank Nationalisation Act, 1970/1980\textsuperscript{42}. The Bank nationalization Act provides for the appointment of one officer of the RBI on the Board of PSB's\textsuperscript{43}. The Statute also lays down what interest they should represent and their qualification -- formal or otherwise\textsuperscript{44}. There are nominees of both the regulator and the Government on the Board of PSB's\textsuperscript{45}. In addition, the statute provides for appointment of directors representing specific interest groups like depositors, small scale


\textsuperscript{42} Sec.10B and 36AA of the Banking Regulation Act, 1949 and Section 7 and 8 of the Bank Nationalisation Act, 1980.

\textsuperscript{43} Sec.8 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

\textsuperscript{44} Sec.9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

\textsuperscript{45} \textit{Ibid.}
industry, agriculture and professionally qualified persons\textsuperscript{46}. The Government as owner takes into account the expertise, the knowledge and skill of the candidates before appointing them on boards. The RBI has the right to appoint the nominee on the boards of private banks.

In regard to the composition of the Board, Ganguly Committee\textsuperscript{47} has made comprehensive recommendations and these have been approved by the RBI. The following are the important ones:

a) Boards should have more professionals by inducting technical and specially qualified persons;

b) Directors should fulfill certain fit and proper norms, viz. formal qualifications, experience and good record. To ensure this, companies could call upon the candidates for directorship to furnish necessary information by way of self-declaration, verification reports from market, etc.

c) Certain criteria adopted for PSB’s such as age of Director being between 35 and 65, that he or she should not be a member of

\textsuperscript{46} Sec.10A of the Banking Regulation Act, 1949.

\textsuperscript{47} Supra, n.32.
Parliament/State Legislature, etc. may be adopted for private sector banks also;

d) Selection of Directors could be done by a nomination committee of the Board RBI also might compile a list of eligible candidates.

e) The banks may enter into a “Deed of Covenant” with every non-executive director, delineating his/her responsibilities and making him abide by them;

f) Need based training should be imparted to the Directors to equip them properly in governing the banks.

The recommendations boil down to two simple requirements, that is competence and integrity of persons appointed as Director. The suggestion that Directors should be selected by a nomination committee would call in question the role of shareholders in appointing them. Both in law and in practice, Directors are elected by shareholders and this right ought not to be abridged or taken away only in banks. Thus Ganguly committee’s observation that the final decision in respect of independent/non-executive directors should be that of the Board flies in the face of well settled laws on the subject.\footnote{Rita Rai, \textit{Issues and solutions in implementing Corporate Governance in the Banking Sectors}, Bank Economists Conference (2002), p.5.}
Another related matter is the role and responsibilities of the Chairman of the Bank. It is a fact that the Companies Act does not recognize a Chairman for any Company, unless the Articles of Association specifically provides for the post. However, conventionally, almost all companies have a chairman. Regulating Banking, the B.R.Act specifically provides in section 10B that every banking company shall appoint one of its Directors as Chairman on a whole-time or part-time basis.\(^{49}\) By convention, the C.E.O. of a bank is appointed as Chairman, in many cases, he/she is called Chairman-cum-M.D. Only in a few new private sector banks had a person who is not an executive of the banks appointed as Chairman. There is a lot of merit in having a non-executive Chairman.\(^{50}\) The Chairman is the presiding officer of the Board and also chairs the general body meeting of shareholders. There could be occasions where the actions of the C.E.O. need to be reviewed by the Board. Even where the C.E.O. is not directly involved in the decision or action that is under scrutiny, he/she is likely to own those decisions/actions. This apparent conflict of interest is duly recognized by the R.B.I. in the formation of audit committees, in which the C.E.O. is prohibited from taking part. Therefore it would be desirable that a person unconnected either presently or in

\(^{49}\) See Appendix VIII.

the past, with the management of the bank is chosen as Chairman, otherwise the Board might not be able to oversee the actions of the management in an unbiased manner\footnote{Ibid.}.

The Government has continued with the composite position of Chairman-cum-M.D. in the P.S.B's despite the many recommendations\footnote{Cadbury Committee Report 1992.} to separate the role of Chairman and C.E.O. From the stand-point of independence and objectivity and ethical practices, universally the move is to separate the functions of Chairman and the C.E.O./M.D. This is only right since a singular position implies the C.E.O. reporting to himself and reviewing his own performance\footnote{Colin J.Thomas, \textit{Company Boards and Directors}, Management Review (1997).}.

The most critical issue is the role of the C.E.O. of the bank. Time and again it is proved that the leadership of the organization is a decisive factor in its performance. The banks with a track record of good performance suddenly start experiencing set backs under a new C.E.O. In contrast, there are instances of a C.E.O. causing turn around in a bank which has almost been written off. In both occasions the structures and the people were the same. His
experience, professional skills, a proven record of performance and his value systems have a direct influence on the overall performance of the bank. As U.S. President George W. Bush said, the burden of leadership rightly belongs to the C.E.O. They set the ethical standards for their companies. They set a moral tone by the decisions they make, the respect they show their employees and their willingness to be held accountable for their actions, by showing their disapproval of other executives who bring discredit to the business world.

From the Bank's point of view, the focus should be on C.E.O's selection, his tenure and accountability for failures and any governance must address these issues. The leadership provided by him can have an enduring impact on team building, on developing a sound line of succession and promoting a value system to be imbibed by everyone in the organization.

Committee of Directors

In the governance of corporates, it is practically impossible for all the Directors to be involved in all areas of functioning of banks. Therefore the job is delegated to certain committees of the Board. Sanction of loan and other

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55 In his address to Business Barons, at New York on 9th July (2002).

56 Ibid.
credit exposures are done by executive committee of the Board in S.B.I. and by the Management Committee in other P.S.B's. This system has a lot of merit. But the basic question is whether the sanction of loans and credit exposures to customers should be done by the Board or its committee or the job could be entrusted to the executives? If needed, a report is to be made to the Board for sanction of larger exposures. But in practice it is observed that despite the Boards or their Committee sanctioning the large exposure in banks, over the years, the quality of credit exposures does not seem to be in any way superior, as witnessed by the large volume of non-performing assets in banks. In large international banks, Boards do not seem to be taking decisions on individual exposures, however, large they may be59.

**Oversight by top-management**60
(Role of senior management and auditors)

Senior management is a key component of corporate governance. While the Board of Directors provides, check and balances to senior managers

57 *Role of Board of Directors in Emerging Dimensions of Corporate Governance*, Chartered Secretary, May (1997).

58 *Ibid*.

59 Reported in Time, October 7 (2002).

60 *Reshaping the Bank – Towards the new era of capability based restructuring*, A Joint Study on the future of Banking, the Banker and Accenture, October (2001).
senior managers should similarly assume that oversight role with respect to line managers in specific business areas and activities. Even in very small banks, key management decisions should be made by more than one person.

Through a well-structured machinery, the top management monitors and supervises the working of the organization from time to time. Internal audit, vigilance and internal loan review departments are a few arms headed by senior management functionaries to assist the board in overseeing the working. The working of such arms comes up for the scrutiny of the board from time to time.

**Internal and External Audit**

The internal and external audit of banks has a very wide sweep today. There are audits at different levels and by different agencies. Internal audit by qualified and experienced officials goes-on on a continuous basis. RBI conducts inspection\(^6\) periodically. Concurrent audit is assigned to qualified professionals. Apart from all these, professional chartered accountant firms undertake what is known as statutory audit. The findings of these agencies provide valuable insight to the boards in evaluating the controls and

\(^6\) Sec.35 of the B.R.Act 1949.
monitoring function and in laying down policies relating thereto to safeguard the interest of stakeholders. After the 1992 securities scam, the audit function has been given a crucial role in banks' working. A special Committee known as the Audit Committee of the Board, oversees the entire audit function of the bank.62

**Role of Supervisor**

The Basel Committee63 emphasises that the supervisors should be aware of the importance of corporate governance and its impact on corporate performance. Supervisors should be attentive to any warning signs of deterioration in the management of the bank’s activities. They should consider issuing guidelines to banks on sound corporate governance and the proactive practices that need to be put in place. It is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.

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63 Ibid.
The Bank for International Settlements (BIS)\textsuperscript{64} emphasizes in its paper that Banking supervision cannot function if sound corporate governance is not in place and consequently bank supervisors have a strong interest in ensuring that there is effective corporate governance in every banking organisation. Supervisory experiences underscore the necessity of having the appropriate levels of accountability and checks and balances within each bank. Sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors\textsuperscript{65}.

The BIS document on corporate governance for banks refers to a management structure composed of a board of directors and the senior management. The committee recognizes that there are significant differences in the legislative and regulatory framework across countries as regards the functions of the board of directors and the senior management. In some cases, it is also known as a supervisory board, the board of directors and senior management.

\textsuperscript{64} Supra, p 241.

Principles of governance will naturally differ from country to country depending on the prevailing corporate structure and legal framework. Also one uniform set of guidelines may not serve the purpose for all organizations, variations occur based on ownership status, culture and climate. Broadly there are few models of corporate structure that have evolved over time in the developed world.

*International Perspective*

Corporate governance in the financial sector is prominent because the costs can be severe when governance is poor. Every one of the major economic crises in emerging market countries in recent years – in East Asia, Russia, Turkey, Brazil and Argentina – has been accompanied or has been triggered by a crisis in its financial sector and in the process, the citizens have suffered deep pain\(^{66}\). In the case of Indonesia, which was hit hardest during the Asian financial crisis\(^{67}\), the fiscal costs alone of having the Government step


into make good the obligations of the privately held banks exceeded 100% of the country’s G.D.P. 68

Financial crises also typically entail large social and economic costs, which are visited not only on the wealthy who have something to lose, but also throughout the population of countries where employment opportunities dwindle and wages collapse, when G.D.P. drops sharply and currency value plummets. The concept of corporate governance has gained importance with the emergence of joint stock company which brought about a clear schism between ownership of capital and its control. The U.S. authorities had set up a national commission on fraudulent financial reporting 69. It was the gathering forces of globalisation during the last two decades of the 20th Century, which have initiated the interest in the various issues related to corporate governance.

The numerous committees across the Globe which have gone into the gamut of issues relating to corporate governance were the Macdonald


69 The Treadway Way Report, 1887.
Report\textsuperscript{70}. The Cadbury Report\textsuperscript{71}, Toronto Stock Exchange Committee Report\textsuperscript{72}, the Nolan Committee Report\textsuperscript{73}, etc.

In developed countries like U.S.A. and U.K. good governance aims at ways in which the strong outside shareholders and stock holders can influence the behaviour of the inside management. A significant development leading to the universalization of the concept of corporate governance was the endorsement in May 1999 of the "OECD Principles of Corporate Governance (1998) by the ministers of the 29 countries comprising the organisation for economic co-operation and development. These principles became signposts for activities in this area not only in the Trans-Atlantic World countries but also in organisations like IMF, World Bank and the United Nations\textsuperscript{74}.

With the growing complexity in organisations, management of variety of risks became paramount. It was observed that a large number of corporate failures were caused by absence of effective risk management


\textsuperscript{71} Report on the financial aspects of Corporate Governance (1992), U.K.

\textsuperscript{72} Report on the Toronto Stock Exchange on Corporate Governance (1994), Canada.

\textsuperscript{73} Report of the Committee on Standards of Conduct in Public life (1995), U.K.

\textsuperscript{74} St.Goa Junny, Banking towards a new Millenium, The Economist, Intelligence Unit (2000), London.
systems. Accordingly, the Turnbull Guidance laid down responsibility on the Board of Directors to ensure and confirm the installation of an on-going process for identifying, evaluating and managing key business risks.

The corporate format in U.S.A. has essentially been built on individualisation and enterprising capabilities of individuals. They considered that corporations were not to be utilized solely for business transactions of individuals.

**United States of America**

In U.S.A. the major focus of good corporate governance is shareholders 'rights'. But recent disclosures on treatment of stock options and certain post-retirement arrangements of C.E.O’s of the best managed and best performing corporations indicate instances of C.E.O’s greed and utter disrespect of stakeholders. The spate of corporate misdemeanors has therefore cast doubt on the efficiency and effectiveness of the board and auditors in U.S.A. People have also started questioning the efficiency on the part of

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regulatory and supervisory agencies, accounting standards and other market participants such as investment bank analysts and rating agencies\textsuperscript{78}.

A close look at the number of authoritative accounting guidelines in U.S.A. shows that it has the most detailed disclosure requirements and accounting standards. As of now there are 141 Financial Accounting Standards issued by the Financial Accounting Standard Boards as compared to 41 by International Accounting Standards\textsuperscript{79}. But the recent collapse of world-giants like U.S. World.Com and Enron in U.S.A. has highlighted that only compliance with corporate governance requirements does not necessarily guarantee good financial reporting outcomes, if the individuals within do not operate with the right degree of independence, with the right kind of expertise and do not devote the required amount of time to their important note. It has highlighted the need for self-discipline\textsuperscript{80}.

The U.S. came out with its toughest ever law in the form of Sarbanes-Oxlay Act of 2002 to restore the confidence of the investing public.

\textsuperscript{78} W.Rogen Ferguson, \textit{Convergence of Regulatory Standards}, Institute of International Bankers, Washington, 6 March (2000).


It enunciates 3 major changes in the way corporate frauds can be curbed. Firstly, the Act provides for setting up of an independent Public Company Accounting Oversight Board functioning under the direct supervision of the Securities and Exchange Commission. This Board will establish standards in respect of auditing, quality of control, ethics, independence, etc. It has the power to conduct investigations, initiate disciplinary proceedings and impose sanctions on the erring firms. Secondly, the Act makes the C.E.O. and Chief Financial Officer of a company accountable for all the information provided in its financial reports. The Act also provides for fine\textsuperscript{81} for willful and deliberate violations. Thirdly, the Act provides for giving protection to whistle blowing employees for passing on information relating to wrong doings of the company to federal officials, company supervisors and congressional members\textsuperscript{82}. To facilitate the implementation of the above structures, many Acts have been amended in the U.S. The Corporate and Criminal Fraud Accountability Act of 2002 amends the Federal Criminal law to impose criminal penalties,- (i) for willfully destroying, altering, canceling or falsifying records with intent to obstruct or influence either a federal investigation or a matter of bankruptcy,

\textsuperscript{81} Upto 20 years imprisonment.

\textsuperscript{82} U.S. House of Representatives (2002), Sub-Committee on Capital Markets Securities and Government sponsored enterprises, 24\textsuperscript{th} June, Washington.
(ii) Failure to maintain for a 5 year period all audit or review work papers to an issuer of securities. The White Collar Crime Penalty Enhancement Act of 2002 amends the Federal Criminal Law to, (i) establishment of criminal penalties for attempt and conspiracy to commit criminal frauds, and (ii) increase criminal penalties for mail and wire frauds. Similarly, the Corporate Fraud Accountability Act of 2002 amends the Federal Criminal Law to establish a maximum 20 year prison term for tampering with a record or obstructing official proceedings.

United Kingdom

In U.K., the major focus of corporate governance is on board structure, processes and accountability. The board operates usually with a majority of non-executive directors. They always separate the role of the chairman and C.E.O., especially since the Cadbury Review of corporate governance in 1990s. The role of Audit Committees has been greatly

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84 Ibid.
enhanced. There is a single unified Regulatory Board, ie., Financial Services Authority under the Financial Services and Market Act\textsuperscript{85}, 2000.

In U.K. the concept of corporate governance is largely entrenched in the traditional theory of the firm which advocates that the only objective of the companies is to maximise profits and to consider shareholders' welfare its paramount consideration. This structure of corporate governance mandates directors to carry out the shareholders' direction. Directors are therefore perceived as agents for their shareholders\textsuperscript{86}.

Certain sections of the Act\textsuperscript{87} state that the auditor is an integral part of the regulation and supervision of authorized persons in supervising the banks. It aims to protect depositors and not the interests of shareholders. Directors are required to certify material disclosures and they are treated as approved persons. The Cadbury Committee Report\textsuperscript{88} deals with the conformance role of the Board and as such does not cover the total ambit of a board's functioning. This may be due to the fact that in these countries the

\begin{itemize}
  \item \textsuperscript{85} FSA under FSMA 2000.
  \item \textsuperscript{86} The Economist, London, 1\textsuperscript{st} May (2002).
  \item \textsuperscript{87} Sections 166, 340 and 346 of the Financial Services and Market Act (2000), U.K.
  \item \textsuperscript{88} Similar to the compact for owners in U.S.A.
\end{itemize}
performance role of the board is also essentially taken up by the C.E.O. and top management team. The Board primarily focuses its attention on creating the checks and balances needed over the executive management and protecting the interests of the stakeholder.

The Cadbury Code stresses that where the Chairman of the Board also happens to be the C.E.O.\(^8^9\) it is essential that there should be a strong independent element on the board with a recognised senior member. The Australians perspective on the corporate governance is more oriented towards the performance of the Board. While in the German system, there are two levels of boards responsible for setting the direction and running the business, reporting to the supervisory boards, which approve corporate plans and proposals and monitor performance on behalf of the shareholders and the employees\(^9^0\).

**India**

In developing countries like India, the major emphasis of O.E.C.D. principles of corporate governance is on protection of shareholder’s rights, protection of stakeholder’s right and timely and accurate disclosure of all

\(^{89}\) Similar to the position in India.

material matters including the ownership and governance. Regarding the protection of stakeholder’s rights, the OECD principles emphasize that the corporate governance framework should assume that the rights of stakeholders that are protected by law are respected and that stakeholders have the opportunity to obtain effective redress for violation of their rights. The Basel Committee’s supervisory standards have also adopted these principles.

In India, to promote and raise standard of corporate governance in respect of listed Indian companies, including the banks, the Kumara Mangalam Birla Committee Report and clause 49 of SEBI provide both mandatory and recommendatory ways, which include board structure processes and disclosure on material matters. In order to complement the corporate governance rules of SEBI, the Government of India has constituted the Naresh Chandra Committee to look into various aspects of Auditor-Company relationship and regulatory auditors. The Institute of Chartered Accountants of India have started a move to tighten its rules, to make the Indian auditing standards


consistent with International Standards on Auditing and to fix accountability. The Institute has also debarred practicing Chartered Accountants from withdrawing any report once it has been submitted, while the Department of Company Affairs is considering stricter punishment norms for auditor misconduct which include imprisonment up to 10 years.

*Narasimham Committee Recommendations*

The Narasimham Committee discussed the issues related to corporate governance in banks and based on it, the advisory group on corporate governance set up under the aegis of RBI suggested major reforms in the constitution of the Boards. The Committee opines that there is a need to set up an expert body on the lines of UPSC which appoint the Chairman, Executive Directors and non-executive directors of the Banks. Further, owing to its role as regulator, RBI need not have representation on the Board of PSB's as it leads to conflict of interest. Another factor noted here is even

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94. The Institute of Chartered Accountants of India (1994), Guidance Note on Audit of Banks, New Delhi.

95. Supra, p.80.


after having a representative on the board, having its own information and warning signals about the impending problems in a bank, problems are still rampant and defy solution. The public is yet to get a convincing response to this legislative doubt. Has the system failed or the people behind it? There is a need to make the regulator's role more purposeful and anticipatory.

To sum up effective governance of banks must have the following minimum criteria:

i) The basic objective of governance should be safeguarding depositor's money and optimizing shareholder's interests.

ii) The Directors should be competent and persons of integrity.

iii) The Chairman of the Board should preferably be unconnected with the management of the bank.

iv) The Board can function through committees and risk management committee assumes special importance in the context of rapid changes taking place in the financial markets. In measuring and monitoring risks, the Board should enlist the assistance of experts.

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99 Ibid.
v) The Board should forbid banks from pursuing business which might be proper in form but highly improper in substance.

vi) As a general rule, the Board should ask the management to spell out as to when a transaction could result in losses and on the basis of the overall risk of bank, the transaction may be approved or rejected.

vii) Suitable risk and reward system should be put in place for the directors of banks.

In conclusion one can say that in the global world and in the present era of rising competition capital flow in Indian banks bears a direct relationship with the degree of good corporate governance. So it is the quality of corporate governance that counts for as a critical factor in survival and in brand building and also provides for a potential source of competitive advantage for raising funds from the capital market. The banking sector must therefore gear up earnestly to meet the hard gaze of market scrutiny and stringent supervisory norms. However, corporate governance does not become good governance merely because the auditor gives a certificate to that effect. The key to good governance goes beyond statutes and regulations and includes commitment to core values, ethics, culture and making a distinction between
‘personal funds’ and ‘bank’s fund’. There is a need to make the individuals within it operate within the clear lines of responsibilities and accountability, with the right degree of independence, with right kind of expertise and with the required amount of time\textsuperscript{100}.

In addition good governance is also required for development of human capability to perform its rightful function. In fact, availability of skilled and knowledgeable persons is a basic building block for adoption of good governance practices. According to K.B.Dadiseth, “it is not the rules and regulations and the Committees and the number of non-executive directors that is relevant. More crucial is the software, creating a corporate conscience and consciousness, the culture of transparency and openness in the organisation, the confidence that every person in the corporation will know and do on his own what is right”\textsuperscript{101}. While banking industry has miles to go to attain this level, the emphasis as well as the efforts in other plans of reorienting the structure should aim towards this goal.

\textsuperscript{100} Madhava Godbole, \textit{Corporate governance: Myth and Reality}, Economic and Political Weekly, July (2002).

\textsuperscript{101} The quoted by K.B.Dadiseth in the 32\textsuperscript{nd} A.D.Shroff Memorial Lecture under the Forum of Free Enterprise in Bombay, October (1997).
CHAPTER IX