## CHAPTER 5
CORPORATE GOVERNANCE IN THE BANKING SECTOR

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“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 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.”

Report of the Committee on Corporate Governance of the Securities and Exchange Board of India, 2003

5.1: INTRODUCTION

Corporate governance is of great consequence for markets all around the world. This is because financial and economic development revolves around good corporate governance practices. Research studies have proved that financial development in a country depends on investor protection in that country. A high quality of investor protection leads to more developed stock markets. Corporate governance and economic development are inter-linked. Efficient corporate governance systems encourage the development of robust financial systems. Efficient corporate governance practices provide increasing returns to investors by lowering cost of capital by reducing risk. This creates superior firm valuation. Secondly, with effective corporate governance mechanisms in place, banks can ensure better allocation of resources.

Banks play a crucial role in the flow of capital. Banks are an imperative constituent of any economy. Hence, the proper governance of banks is very crucial for growth and development of the economy and the country as a whole. The banking system in a country tends to be heavily regulated with restrictions and prudential requirements. This is because failure of one institution may have a cascading effect resulting in the failure of other
institutions leading to significant costs to the economy. Fundamentally, banks must act in a way that promotes “confidence” to its stakeholders. Good corporate governance and supervisory actions harmonize one another. Administrators have to depend on the skills and competence of the board.

Banks engage in the business of accepting deposits and giving loans. They lend money borrowed from depositors to customers who apply for loans. Thus, the collapse of banks will result in monetary loss for the depositors. It is imperative that the interests of depositors be protected. This is also one of the main reasons for corporate governance assuming greater importance. Poor corporate governance practices can result into bank failures. These mean significant costs to all stakeholders and also the economy in general. There is also possibility of broader macroeconomic implications. Poor corporate governance can also affect the ability of a bank to properly manage its assets and liabilities. This can result into a liquidity crisis. The fact remains that corporate governance approaches will differ among different banking institutions. However, a bank must have a reasonable level of corporate governance taking various aspects into consideration such as its size, activities and the nature of its business.

Good corporate governance standards include

1. Establishing standards of conduct and ethical behaviour for directors, senior management and other employees.
2. Conducting proper regular checks to get acceptable and satisfactory assurance that the bank has an effective corporate governance mechanism in place for ensuring observance to these pre-determined standards
3. Setting up the responsibilities and also accountability requirements of the board.
4. Setting up terms for appointment of qualified and capable individuals to senior management positions.

5. Conducting checks on a regular basis to evaluate the effectiveness and of senior management in managing the operations of the bank.

6. Supervising strategic management and oversee risk management by establishing appropriate procedures for managing risks.

5.2: THE SIGNIFICANCE OF CORPORATE GOVERNANCE IN THE BANKING SCENARIO

The most important factor for any economy’s growth and development is ensuring effective governance. This is because corporate governance promotes the efficient use of scarce resources. It also makes these resources flow to those sectors or entities where there are efficient production of goods and services and the return is adequate enough to satisfy the demands of stakeholders. In addition, corporate governance provides a broad mechanism of choosing the best directors on board to govern these meager resources.

Various corporate governance structures for banks exist in different countries. Appreciating the diversity in structure of corporate governance mechanisms across the world, the Basel Committee in 1999, recommended four important forms of oversight that should be included in the organisational structure of any bank in order to ensure the appropriate checks and balances. They are

(i) oversight by the board of directors or supervisory board;

(ii) oversight by individuals not involved in the day-to-day running of the various business areas;

(iii) direct line supervision of different business areas;
(iv) Independent risk management and audit functions. The committee also emphasizes on the importance of key personnel being fit and proper for their jobs.

The problems of poor corporate governance are matter of concern in most of the developing and underdeveloped countries. The situation is same in India where corporate governance can be useful in providing the appropriate structure in any system by placing right objectives and goals in front of the organisation and helping the organisation to attain these goals. It helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Corporate governance in banks also boosts the confidence of investors. It reduces the risk of capital outflow from an economy and at the same time, increases the flow of capital in the economy. Subsequently, the cost of capital becomes lower for these banks. The degree of adherence to the basic principles of governance by the banks at the corporate level enhances the confidence of the investors of those banks as shareholders and potential investors require access to regular and reliable information in detail for them to assess the management. 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.

Most countries have adopted financial deregulation as a means of reform of national financial systems. Even then, banking continues to be a completely regulated area. There is no country around the globe that has adopted a complete laissez-faire approach. The main reason for corporate governance assuming augmented significance in our country has been globalisation, which has bought with it mounting competition. Globalisation has made an impact on all companies and banks, public and private.
more competitive and highly volatile global environment than other organisations. They are instrumental in providing finance for commercial enterprises. They also provide basic financial services to a broad segment of the population. Besides, some banks also make credit and liquidity available in difficult market conditions.

The corporate governance of banks is different and unique from that of the other organisations. This is because the activities of the bank are less transparent than other organisations. Thus, it becomes difficult for shareholders and creditors to monitor the activities of the bank. The situation becomes even more difficult when a major part of the share capital is with government. Additionally, banks also differ from most other companies in terms of the complexity and range of their business risks, and the consequences if these risks are poorly managed.

The Banking Sector in India has definitely not remained unaffected to the developments taking place worldwide. Enhancing the level of corporate governance structure of Indian banks is imperative. The regulatory bodies in India are the Reserve Bank of India and the Securities Exchange Board India. The RBI prescribes prudential principles and norms. The RBI performs the corporate governance function under the Board for Financial Supervision (BFS). The BFS, in turn, supervises the working of the Department of Banking Supervision (DBS), Department of non-Banking Supervision (DNBS) and Financial Institutions Division. The SEBI is a regulatory authority regulating the securities market. Its authority extends up to only companies listed in the two stock exchanges in India, namely the NSE (National Stock Exchange) and BSE (Bombay Stock Exchange). The compliance of the corporate governance code is mandatory for listed banks.
The Banking System in India is becoming more and more complex and open, and hence, it is at this juncture, that a need for qualitative standards is felt. Qualitative standards include standards such as internal controls, composition and role of the Board, disclosure standards and risk management. Such disclosure standards would put India on par with international standards. Recent developments have shown that inadequate corporate governance standards in banks and financial institutions result into economic susceptibility. Detrimental developments taking place in one bank or financial institution can generate similar cyclical effects in other banks or financial institutions. Inadequate corporate governance arrangements in banking systems include inadequately qualified and experienced bank directors, and directors with significant conflicts of interest; insufficient understanding of the nature of banking risks by a bank’s directors and senior management; inadequate representation of non-executive and independent directors on the board; inadequate risk management systems, internal controls and internal audit arrangements; insufficient accountability of directors; inadequate oversight of senior managers by boards of directors, and poor quality financial reporting to the board; insufficient rights for shareholders.

5.3: **EVOLUTION OF CORPORATE GOVERNANCE IN THE BANKING SECTOR IN INDIA**

There were a few regulatory guidelines related corporate governance of banks before the banking reforms. Prior to this, the Indian banking industry was characterized by the dominance of public sector banks. In contrast to this, there were very few private banks. The reforms of 1991 saw a striking transformation in the banking sector in India. A lot of private sector banks entered the industry and government shareholding in public sector banks went down. Liberalization also saw the entry of foreign banks on the Indian
banking scene. The entry of foreign banks and private sector banks bought with it growing competition. This compelled all banks to improve their governance structure to take care of ever-increasing customer needs. Banks now had greater freedom and were given increased autonomy and responsibility. The entry of institutional and retail shareholders also resulted in improvement of corporate governance standards.

The East-Asian crisis was instrumental in giving a new shape to corporate governance. Since then, many institutions have taken the initiative to contribute to the development of corporate governance. The OECD formed its corporate governance principles in 1999. They were again revised in 2004. The Basel Committee on Banking Supervision published guidelines on corporate governance in banks in 1999. These norms are followed by banks all over. The most recent of these are known as the Basel III norms. A series of scandals in the United States led to reforms in corporate governance and disclosures in that country. In July 2002, the Sarbanes-Oxley Bill (also known as SOX) was enacted. The Act contained changes in several areas of corporate governance like financial disclosures and auditor responsibility.

In India, the first announcement in regard to corporate governance was made by Dr. Bimal Jalan, Governor of the Reserve Bank of India in 2001. An advisory group on corporate governance was formed under the chairmanship of Dr. R.H. Patil. It submitted its report in March 2001. This group looked into issues relating to corporate governance in banks in India. It then made recommendations to bring the governance standards in India on par with the best international standards. A Consultative Group was then constituted in November 2001 under the chairmanship of Dr. A.S. Ganguly. This group was formed to strengthen the internal supervisory role of the Boards. The report of the Ganguly Group was sent to all the banks and also
the Government for consideration in June 2002. Subsequently, the advisory
group on Banking Supervision under the chairmanship, Shri M.S. Verma
also submitted its report in January 2003. The Reserve Bank then took
measures to strengthen the corporate governance in the Indian banking
sector and to try to bring it at par with international standards. On 21 August
2002, the Department of Company Affairs (Ministry of Finance and
Company Affairs) instituted a committee to look into various corporate
governance issues in the country.

5.4: CORPORATE GOVERNANCE AND THE GLOBAL
BANKING SCENARIO

Banks are different from other companies in a variety of ways. The main
point of difference is the capital structure of banks and the liquidity creation
function. Firstly, deposits made by the depositors of the bank constitute the
liabilities of banks. These are available on demand. Assets of the bank, on
the other, have a comparatively longer maturity period. Therefore, banks are
able to create liquidity. Secondly, banks have very little equity as compared
to other organisations. Many differences in exist in banking corporate
governance systems the world over. Some of them have been elicited below.

1. United States of America

In the United States of America, banking regulation has essentially
been the function of federal and state banking regulators, the main
objective being safety and soundness of the banking system. The
main doctrine of American corporate governance is that the duty of
managers and directors is to maximize firm value for shareholders.

2. United Kingdom:

Banking regulation in the United Kingdom is essentially the function
of the Financial Services Authority. It oversees the internal control
and compliance systems of all banks. In May 1991, a committee
chaired by Sir Adrian Cadbury was established to make recommendations to improve corporate control mechanisms for all companies in the United Kingdom. The Committee published a final report in 1992. On 1 November 2003, a revised Combined Code came into effect. The FSA follows this code.

3. United Arab Emirates
The banking sector in this region is characterised by family-controlled banks. The main regulatory bodies in the UAE corporate sector are the Ministry of Economy, the Central Bank, and the Emirates Securities & Commodities Authority (ESCA). Regulatory authorities have taken efforts to raise awareness of sound corporate governance practices and non-listed organisations have also been subject to stringent corporate governance requirements.

4. Germany
The Deutsche Bundesbank is the central bank of the Federal Republic of Germany. Along with the Federal Financial Supervisory Authority, the Bundesbank is responsible for continuous oversight of the solvency, liquidity, corporate governance and risk management systems of the banking sector in Germany.

5. France
The Banque de France (Bank of France) is the regulatory authority in France and ensures the implementation of the common monetary policy as defined central banks of the eurozone. The French corporate governance code was first laid down in 1995 by a committee guided by Marc Viénot.

6. Australia
Australia's banking regulatory authority is the Australian Prudential Regulation Authority (APRA). Banks also have to provide information under the Anti-Money Laundering and Counter-Terrorism Financing Act 2008. The corporate governance
framework is provided by the Australian Securities Exchange (ASX) Corporate Governance Council.

5.5 APPLICATION OF CORPORATE GOVERNANCE IN THE BANKING SECTOR— THE MODERN CONTEXT:

Corporate governance is evolutionary and ever-changing. Banks must innovate and adapt their corporate governance practices in order to remain competitive. It may be noted here that there is a basic difference between the private sector banks and public sector banks as far as the Reserve Bank’s role in governance matters relevant to banking is concerned. The current regulatory framework relating to prudential norms set up by the Reserve Bank of India gives the same treatment to private banks and public sector banks. However, where governance aspects are concerned, the Reserve Bank prescribes the policy framework only for private sector banks. For public sector banks, it forwards suggestions based on the same framework to the Government for consideration.

The reforms have resulted in many changes to the banking sector in India, including in the areas of corporate governance. Competition is being encouraged as more and more banks are being issued licenses. Greater independence is being given to boards of public sector banks. The nominee directors are being increasingly replaced by independent directors. This is being done with a view to increase professional representation on boards of public sector banks to increase the level of competence. Even though regulatory bodies around the globe define standards for corporate governance, it is the primary responsibility of the bank to develop sound corporate governance practices for itself.

In India, the need for better corporate governance and disclosure norms was felt due to the string of scams and scandals that shook the country post
1990. Also, liberalization resulted in massive international competition. This also forced companies and financial institutions to adopt best standards. The Securities Exchange Board of India also made it compulsory for companies to adhere to norms mentioned in the Clause 49 of the Listing Agreement from April 2001. Listed companies and banks in India are required to follow very strict guidelines related to corporate governance. Indian corporate governance guidelines are amongst the best in the world. However, corporate governance in India is followed in letter rather than in spirit. Rampant corruption and inefficiencies of the legal system to combat and fight this corruption has resulted in poor performance. However, the establishment of corporate governance practices in the banking sector has been hindered by an inefficient legal protection system and inadequate disclosure requirements. Also, in many countries, bank corporate governance is often influenced by political intervention in the banking system.

In India, the partial divestment of public sector banks has not made any significant change to the quality of corporate governance in public sector banks. The Government still plays a major role in appointing members to boards of banks. Furthermore, in spite of greater autonomy being given to banks, they still follow the directives issued by the government.

5.6: CORPORATE GOVERNANCE AND INDEPENDENT DIRECTORS:

The Indian corporate sector has been largely dominated by family-owned businesses since a long time. However, in the recent years, this aspect has resulted in major criticism. Many argue that this might not lead to highest levels of transparency, disclosures and accountability. This is mainly due to the fact that family members who have been stakeholders in these
companies have not found it important to maintain a certain level of disclosures. This has resulted in insufficient dissemination of information to all stakeholders. It has also highlighted the need for Independent directors to be on the boards of all companies and organisations.

The main rationale behind the appointment of independent directors is their capability of decision-making without any conflict of interest. This leads to a higher level of accountability in the organization. It also leads to an effective composition of the board.

The Securities Exchange Board of India had constituted a Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy to improve corporate governance standards in India. On 26th August 2003, the SEBI issued a circular introducing a major amendment to the Clause 49 of the Listing Agreement wherein the definition of an Independent Director was also amended. According to this circular, “Independent Director is one who:

• is not related to promoters or management at the board level or at one level below the board;

• has not been an executive of the company in the immediately preceding three financial years;

• is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.

• is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and

• is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.”
In India, the Companies Act provides for extra compliances for whole time directors. It also requires disclosure by interested directors. All directors on the board are viewed in the same light and have the same authority, obligations and responsibilities. Each director to be seen as fully accountable to all shareholders. There should be full disclosure concerning each director, including any factors that might affect their independence in decision-making. This should be done with the aim of providing shareholders with all information to enable them to cast their vote correctly. The shareholders should be aware of the value each board member brings to the company/organization.

5.7: CORPORATE GOVERNANCE AND COOPERATIVE BANKS:

Urban Cooperative Banks are a key sector in the Indian Banking Industry. In recent years, this sector has faced a lot of turmoil and turbulence, resulting in bankruptcy and closure of many cooperative banks. The cooperative movement started in India with the enactment of Cooperative Societies Act in 1904. The main objective of such cooperatives was to meet the banking and credit requirements of people. Today, urban cooperative banks play an important role in meeting the growing credit needs of urban as well as semi-urban areas of India.

In 1966, the Banking Regulation Act was made applicable to UCBs. They flourished and grew up to 2003-2004. However, their growth was cut short by inefficient and corrupt board members, which led to gross mismanagement and finally decline in public confidence leading to bankruptcy and closure. This decline in public confidence also led to massive large-scale withdrawal of deposits from banks which remained functional. In India, SEBI, through the Clause 49 of the Listing Agreement,
requires all listed banks to adhere to corporate governance regulations officially. Cooperative Banks, however, are not listed as they do not trade in shares. This is the main difference between cooperative banks and other banks in the banking sector. But the RBI has been making continuous efforts to see that cooperative banks also maintain the highest standards of corporate governance.

Most of the problems faced by the cooperative banks can be attributed to corporate governance issues. Cooperative banks should also take their own initiatives to improve the level of corporate governance subsequently increasing public confidence. An important aspect of corporate governance is the role of directors. The board should formulate a standardized code of conduct clearly explaining the duties and obligations of each director. Immediate family members should not be inducted on the board or in management at the same time. Also, no directors should have a criminal background. All related party transactions should be reported.

5.8: CORPORATE GOVERNANCE AND BASEL NORMS:

The Basel Accord was first established in 1988 by the Basel Committee on Banking Supervision under the Bank for International Settlements. The BIS was established on 17 May 1930 and is the world's oldest international financial organization. The Basel Committee was established by the central-bank Governors of the Group of Ten countries in 1974. It meets regularly four times a year. It has four main working groups. The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.
The Basel Accord was established to provide a set of minimum capital requirements to banks. According to this accord, the banks would be required to maintain a minimum capital requirement a propos the loans given out by them. The 1988 Basel Accord also known as Basel I primarily focused on credit risk. The Central Banks of several countries that have agreed to become signatories have been given the responsibility of enforcing the provisions. In India, the Reserve Bank of India shoulders this responsibility.

The second of the Basel Accords, Basel II was first published in June 2004 and established in 2005. This accord widened the scope of Basel I by establishing capital requirements for market risk and operational risk, in addition to credit risk. Basel II also included provisions which allowed banks to use advanced statistical methods to compute possible losses for which they were required to hold capital. Therefore, international banks had an advantage as they could lower their capital requirements through the use of advanced models.

The third of the Basel Accords, Basel III was created in response to the flaws in financial regulation which led to the crisis and also due to appeals for the reform of capital adequacy and liquidity standards for banks. According to the Basel Committee Report of 1999, Banks have to maintain a certain level of transparency and disclosures in their statements. The annual report should disclose a number of factors relating to the operations of the banks such as accounting ratios, business per employee, related party disclosures and information about NPAs.

5.9: FOREIGN BANKS IN INDIA AND CORPORATE GOVERNANCE

With globalization, the concept of banking has changed substantially over the last couple of years. Many foreign banks have made an entry into the
banking sector in India. The banking industry is now more competitive and customer-friendly. Currently, foreign banks can operate only as branches in India. This means that they have reduced corporate governance requirements as they follow corporate governance regulations that are prescribed by the regulating authorities in the parent country.

Foreign banks like Citibank, HSBC, Standard Chartered Bank, etc are the branches of those banks which are incorporated in foreign countries. Foreign banks are playing a pivotal role in Indian economy. They help the economy by financing the import and export trade of the country. They also receive deposits from the public as fixed deposits and current account deposits. Thus, foreign banks have become the main competitors of Indian banks here in India.

5.10: CONCLUSION

Banks form a crucial link in a country’s financial system and their well-being is imperative for the economy. The significant transformation of the banking industry in India is clearly evident from the metamorphosis of the financial markets. Globalisation has bought with it greater competition and consequently greater risks. In such scenario, implementation of good corporate governance practices in banks can ensure them to cope with the changing environment.