CORPORATE GOVERNANCE IN INDIA: NEED OF THE HOUR

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INTRODUCTION-

Governance is the process of decision making. The structure of Corporate Governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders. 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. Corporate Governance is needed in banks because banks belong to public sector. There they do not compete with each other. The financial crisis exposed flaws throughout financial markets and prompted much investigation into the way banks work. It examines why governance of banks differs from governance of non financial firms and where the government of banks failed during the crisis.[584] In banking parlance, the Corporate Governance refers to conducting the affairs of a banking organization in such a manner that gives a fair deal to all the stake holders i.e. shareholders, bank customers, regulatory authority, society at large, employees etc. From a banking industry perspective, corporate governance involves the allocation of authority and responsibilities, the manner in which the business and affairs of a bank are governed by its board and senior management. It set the bank's strategy and objectives and protects the interest of depositors.

MEANING OF CORPORATE GOVERNANCE-

Corporate Governance is a conscious, deliberate and sustained effort on the part of corporate entity to strike a judicious balance between its own interest and the interest of various constituents on the environment, which it is operating.

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[584] Acharya, J N Carpenter, X Gabaix, K John, 2006, "Corporate Governance in the Modern Financial Sector", edition- 185-188

Adrian Cadbury in UK Enterprise: “A Corporate Governance basically has to do with power and accountability: who exercise power, on behalf of whom, and how the exercise of power is controlled.”

OVERVIEW OF BANK CORPORATE GOVERNANCE-

Effective corporate governance practices are essential in achieving and maintaining public trust and confidence in the banking system. Poor corporate governance can lead to bank failures. This can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance system. Due to poor governance, markets can lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits. Supervisors have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of a bank. [585]Well-governed banks contribute to the maintenance of an efficient and cost-effective supervisory system. Sound corporate governance also contributes to the protection of depositors and may permit the supervisor to place more reliance on the bank’s internal processes. Moreover, sound corporate governance practices can be helpful where a bank is experiencing problems. In such cases, the supervisor may require substantially more involvement by the bank’s board or those responsible for the control functions in seeking solutions and overseeing the implementation of corrective actions. Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability. [586]Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so.

DIFFERENCE BETWEEN GOVERNANCE OF BANKS AND NON FINANCIAL FIRMS-

There are mainly two differences between governance of banks and non financial firms:

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[585] Acharya, V V, I Gujral and H S Shin, “Dividends and Bank Capital in the Financial Crisis”, 2007-2009
[586] Dr Abad Ahmad, “Buisness Ethics and Corporate Governance”, 4th edition, 2013, S K Bhatia Publication

1. Banks may have many more stake holders than non financial firms. Stake holders in bank include debt holders. Debt holders are mainly depositors and the holders of subordinated bank Banks. The stakeholders in a bank include debt holders, which are depositors and the holders of the subordinated debt.

2. The second difference is that business of banks is opaque and complex and can shift rather quickly. Banks can alter the risk composition of their assets more quickly than most nonfinancial industries, and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations.

3. Third difference is related with the role of leverage. In non financial firms, leverage is a source of financing, while in a banking sector it is a factor of production.[587]

NEED OF CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS-

(a) Financial institutions are central to economic activity – banks and a large part of the non-banking financial system (the shadow banking system) undertake credit intermediation. Failures of financial institutions would thus impede the economic growth and would cause serious damage to the system. Economies take longer time to rebound from financial crisis than the business cycle recessions.

(b) Financial institutions operate on a higher leverage. As per a study by the Bank for International Settlement (BIS) for the period 1995-2009, compared to non-financial institutions that had a leverage of about 3, banks operated at a leverage of 18.3 while non-bank financial firms had a leverage of 12.1. Higher leverage makes financial intermediaries more vulnerable to shocks.[588]

(c) Financial institutions, especially banks, deal in people's savings and trust of customers forms the cornerstone of their existence. Any breach of trust leading to loss of confidence is bound to lead to a *run,* not just on a particular bank but on others too who are perceived to have weakness or even similar business models. The non bank financial intermediaries who lose the trust of their lenders would not be able to raise resources at a reasonable cost making it hard for them to operate efficiently and profitably. All these can lead to snowballing effect impairing the

[587] Adams, Renee, Benjamin Hermalin and Michael Weisbach, "Role of Boards of directors in Corporate Governance: A Conceptual Framework and Survey", Journal of Economic literature 48(1):58-107

[588] M L Tannan, "Tannan's Banking Law", 23rd edition, Lexis Nexis

functioning of the entire financial system due to interconnectedness. Good governance ensures customers' and other stakeholders' trust in banks and non-banking financial intermediaries.[589]

(d) Among the financial intermediaries, banks occupy a special place due to their centrality in the transmission of monetary policy and the functioning of the payment and settlement systems. They also are the beneficiaries of deposit insurance which may weaken their incentive for strong management monitoring as well as monitoring by other stakeholders including depositors. Good corporate governance would ensure strong internal controls which would offset the weakened incentive for monitoring. A robust and stable banking system is an absolute necessity for a well functioning economy.

REASONS FOR RECENT INTEREST IN CORPORATE GOVERNANCE-

- Directors must realize that their job is to represent the shareholders and other stakeholders, and not offer themselves as the rubber stamp of the managing director.
- There is a rise of institutional investors and safeguard their interest.
- In the wake of globalization, there are numerous takeover moves in corporate world.
- Advent of investigating reporting in business journals.
- Activism of regulatory bodies such as SEBI.
- Corporate Governance has to do with power and accountability.[590]

THE SPECIFICITY OF THE CORPORATE GOVERNANCE OF BANKS

A bank's failure to follow good practices in corporate governance and the lack of effective governance are among the most important internal factors which may endanger the solvency of a bank. Corporate governance in banks differs from the standard which is due to several issues-

• Banks are subject to special regulations and supervision by state agencies, supervision of banks is also exercised by the purchasers of securities issued by banks

[589] Dr B R Sharma, "Banking law", 3rd edition, 2006, Allahabad Law Agency

[590] Berger, A N and CHS Bouwman, 2009, "Bank Capital, Survival and Performance of Financial Crisis", Mimeo, University of South Carolina

• The bankruptcy of a bank raises social costs; this affects the behavior of other banks and regulators.

• Regulations and measures of safety net substantially change the behavior of owners, managers and customers of the banks; rules can be counterproductive, leading to undesirable behavior management which exposes well-being of stakeholders of the bank.

• Between the bank and its clients there are fiduciary relationships raising additional relationships and agency costs.

• Problem principal-agent is more complex in banks, among others due to the asymmetry of information not only between owners and managers, but also between owners, borrowers, depositors, managers and supervisors.

• The number of parties with a stake in an institution's activity complicates the governance of financial institutions.

In the case of banks therefore, corporate governance needs to be perceived as a need of such conduct of an institution, which would force the management to protect the best interests of all stakeholders and ensure responsible behavior and attitudes

KEY AREAS OF FAILURE OF CORPORATE GOVERNANCE IN BANKS

The confidence of the public (in a bank and the entire banking system) is necessary for a proper functioning of the financial system and economy. Effective corporate governance practices are fundamental to gain and maintain this confidence (BCBS 2006, February). As the recent Edelman "trust barometer" study shows, banks and financial services are the two least trusted industry sectors. Trust is a basic prerequisite for a proper functioning of banks, therefore it is necessary to carry out fundamental reforms that will bring inner harmony and allow the recovery of the public trust. Therefore, an in-depth analysis of the recent crisis causes should be done. Particularly considering that the rules of proper conduct of banking business exist and are being implemented, but it is mainly the deficiencies in corporate governance which are to blame for the recent financial crisis. Analysis of the causes of the crisis lead to indicate several issues requiring a re-structuring and strengthening of standards; these issues concern:

• The role, tasks and responsibilities of the board, as well as its size, organization and composition (members) and the functioning of this body and the assessment of its work.

• Control of bank risk exposure.

• Evaluation of executives and its incentive pay.

• Transparency of the bank supervisory board that allows for the assessment of its activities (both by institutional and private monitoring).

• Ownership structure of banks and the role of institutional investors.

In order to avoid a similar financial crisis in the future, regulators of financial markets are planning to establish standards for sealing the system in these areas.

GOVERNANCE FAILURES THAT LED TO THE CRISIS:

a. *Complex and opaque organizational structures*: There was a massive growth in the complexity of organizational structures before the crisis period, with a view to taking advantage of regulatory arbitrage and also of gaps in regulations.[591]
b. *Proliferation of complex products*: There was a significant spurt in the complexity of financial products in the run-up to the crisis. Abundance of cheap liquidity prodded the participants to innovate ways to deploy the funds and earn a return. Complexity and opacity led to inadequate understanding and mispricing of risk. The long chain of transactions also obfuscated the true risks inherent in the transactions and led to a false sense of comfort.[592]
c. Role of executive compensation: Many view compensation practices as a contributing factor to the current financial crisis. The executive pay structure was designed to enhance risk taking and create value for shareholders but not to protect debt holders. This dynamic was particularly strong in the banking industry because banks are highly levered and their leverage is subsidized. A bank's size and its level of executive pay are highly correlated. Since the deposit insurance system contributes

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[591] A C Fernando, "Corporate Governance: Principles, Policies and Practice", Pearson Education India,2009
[592]Kamal Gupta, "C R Datta Company law",6th edition, 2008, appendix 1, Lexis Nexis

to the size and growth of the firm, it thus contributes to the rate of executive pay in the banking industry.[593]

ELEMENTS OF CORPORATE GOVERNANCE-

The following aspects require special mention while judging the standard of corporate governance in banking institution.[594]

A: Board of directors

B: Transparency

Board of directors-.The board is ultimately responsible for the activities and results of the bank, for the maintenance of stability and financial soundness. The powers and rules of the board are specified in the law and the statute of a bank. The mode of operation should be specified in the rules of procedure of the board. The core competences of the board forming the foundations of the bank activities include: approving and overseeing the strategic objectives of the bank and its corporate values, overseeing the work of the management board and the determination of the scope of the obligations and liability of the management members, the establishment of guidelines for the acceptable level of risk, overseeing the introduction of the management system and assessment of the adequacy and effectiveness of the system. The board has overall responsibility for the bank.[595]

Bank Transparency: Bank transparency has several aspects. The most important is the question of transparency in the activities of the bank and its management and the issue of transparency (and understandability) of reports on the activities of the bank and its results. The question of transparency of the activities of the bank is to a considerable extent linked with its established organizational structure. If complex structures are implemented, the responsibility is blurred; transferring income, cost and risk is easier. Similar effects can be caused by an implementation of matrix structures in related banks. This limits the powers of the management structure for a subsidiary bank decisions are taken by the heads of the divisions at the central level and makes it

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[593] Dewatripont, M , and J Mitchell, 2005, "Risk- Taking in Financial Conglomerates", Mimeo, ESCARES, University Libre, Brussels
[594] Bentone Gup, " Corporate Governance in Banking", 1st edition, "Edward Elywar Publications"
[595] R N Choudhary, "Banking law", 1st edition, "Central Law Publications

more difficult for an overall evaluation of the risk of individual participants of such a holding company.[596] The second issue of the transparency of a bank is openness and transparency of information about its financial health. This is a basic condition for the functioning of effective market discipline, which is the private monitoring carried out by the purchasers of the securities issued by the bank (as well as by clients). Market discipline means that the entity has stakeholders from the private sector, who may suffer a financial loss as a result of the decision of that body, and who can "discipline" bank or affect its activities.

GOVERNANCE FROM THE SUPERVISORY POINT OF VIEW-

The supervisory community has recognized that governance practices are often rather weak before a crisis, and a number of these groups have addressed these issues quite thoroughly. However, while the supervisory community has made progress in the past several years in identifying stronger practices, many of the nuances of governance and incentive conflicts make the regulation and supervision of corporate governance difficult. Often, there are no hard and fast rules, and just when a practice becomes widely accepted as best practice. One of biggest challenges for supervisors is identifying and encouraging best practices while being mindful that one size cannot fit all. From a regulatory point of view, boards and management should focus more on safety and soundness issues. The question is but what governance structure is most conducive to achieving that end, and is it the same at all firms? What is the ideal makeup of a board of directors at a large and complex firm? And how far should supervisors go in criticizing or endorsing firms' governance practices particularly when it comes to the board of directors? One of the most often cited components of effective governance is the ability and willingness of bank boards to challenge management and engage in good dialogue to ensure that the company's actions and decisions take into account the wide range of factors that could affect stakeholders. When the question of expertise of board members arrives, it is natural that the board members cannot be expected to know as much about the business of management. Many have argued that board members at large financial institutions have too many other commitments to be able to devote enough time to carrying out their board responsibilities. On the other side of the argument, banks hold that their

[596] Ferreira D, T Kirchmaier and D Metzer 2010, "Boards of Banks", London School of Economics

firms benefit from the input of individuals that understand global business trends and that can speak to some of the geopolitical issues these multinational firms face. [597]

FACTORS INFLUENCING QUALITY OF GOVERNANCE-

1. Integrity of Management- A board of directors with a low level of integrity is tempted to misuse the trust reposed by shareholders and other stake holders to take decision that benefit a few at the cost of others. This influence the quality of governance.
2. Ability of board- Ability of board members determines the effectiveness of the Board.
3. Adequacy of the process- Board of directors cannot effectively supervise the executive management, if the process fails to provide sufficient and timely information to the board, necessary for reviewing plans and the performance of the enterprise.
4. Commitment level of individual members.[598]
5. Financial reporting – Accuracy and transparency in financial statements and disclosure, internal controls and independent of auditors.

WHAT HAVE BEEN DONE SO FAR IN ENHANCING CORPORATE GOVERNANCE-?

Among the global guidelines further initiatives are set by the Basel Committee. Banking Supervision should be indicated. First of all, "good practices" must be indicated, taking into account the specificities of the banks. General rules intended to improve corporate governance in banks were updated by BCBS in October 2010. The current version of the document contains 14 rules in 6 areas (BCBS, 2010, October):

• Supervisory board practices,

• Senior management,

• Risk management and internal control,

• Compensation policy, Complex or opaque corporate structures,

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[597] Allen N Berger, George R G Clarke, "Corporate Governance and Bank Performance: A joint analysis of the static, selection and dynamic effects of domestic, foreign and state ownership", June 2005, 1st edition
[598] Flannery, M J, 2009, "Stabilizing Large Financial Institutions with Contingent Capital Certificates", Mimeo, University of Florida

• Disclosure of information and transparency

In September 2009 a new supervisory architecture was proposed (which has been operating since January 2011. In June 2010, the EU published a "green paper", referring to the issue of corporate governance in banks and their policies of incentive compensation of management. This document summarizes areas of inefficiency and failures of corporate governance in banks (they are included in the list mentioned above), indicates the already taken pre-legislative initiatives, and for consultation - options for further measures. In addition, the European Commission has developed new arrangements, the essential purpose of which is to increase the effectiveness of risk management in European credit institutions, which should help prevent excessive risk taking by individual banks, and as a result of cumulating excessive risk in the financial system. The new legal framework has three operational objectives:

• increasing the effectiveness of the board of supervision over risk;

• raising the status of the risk management function; and

• ensuring effective monitoring of the risk management by supervisory authorities.

CONCLUSION-

Corporate Governance is a way of life and not a set of rules. The banking sector has been severely criticized for its role in the recent financial crisis. Notably, the weak governance of banks is frequently identified as a major cause of the crisis. Due to deposit insurance subsidy, shareholders in banks have created incentives for taking risks and maximizing leverage, at a substantial cost to other stakeholders.[599] Nevertheless, there do exist bank-specific aspects and requirements why corporate governance in banks has to be considered differently. Currently, regulatory and supervisory institutions and environmental bodies prepare proposals for reforms to strengthen the mechanisms of corporate governance. The analysis of main failures of corporate governance in banks suggests that in order to repair and strengthen the system:

− The scale and scope of banking activities should be diminished, as the current level of financialization is excessive and potentially dangerous for the whole economy; special attention

[599] Dr Alexander Kostyuk, “Evolution of Corporate Governance in Banks”, Publication- Virus Interpress,1st edition

should be paid to systemic risk. The capital and contractual relationships between financial institutions should be monitored and if the linkages would become too strong and concentrated, supervisors should be allowed to interfere in these relationships.

− Bank directors should bear personal responsibility for banks' activities and risk.

− Non-executive directors engagement should be stronger .They should devote more time and commitment to perform their oversight function; nomination of supervisory board members should be approved by the supervisors, the role of independent board members should be strengthened.