Corporate Governance in Banks*

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Let me at the outset commend the achievements of your bank in almost all the performance parameters. It is indeed heartening to see a well functioning and sound bank in the otherwise none too rosy co-operative sector. In fact, there could have been no better tribute to the memory of your great founder Sheth Shantaram Mangesh Kulkarni than to turn in a solid performance year after year, and also at the same time becoming a technologically savvy institution. I congratulate the management team and staff of your bank for carrying forward the vision of your great founder.

Corporate Governance and Co-operative Banks

Coming to the theme of my lecture today, I deem it a privilege to have been invited to address this gathering on a topic of tremendous relevance, focus and significance in today's context. Needless to say, for the co-operative banks in India these are challenging times. Never before has the need for restoring customer confidence in the co-operative sector been felt so much. Never before has the issue of good governance in the co-operative banks assumed such criticality. The literature on corporate governance in its wider connotation covers a range of issues such as protection of shareholders' rights, enhancing shareholders' value, Board issues including its composition and role, disclosure requirements, integrity of accounting practices, the control systems, in particular internal control systems. Corporate governance especially in the co-operative sector has come into sharp focus because more and more co-operative banks in India, both in urban and rural areas, have experienced grave problems in recent times which has in a way threatened the profile and identity of the entire co-operative system. These problems include mismanagement, financial impropriety, poor investment decisions and the growing distance between members and their co-operative society.

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

Genesis of Corporate Governance

It will certainly not be out of place here to recount how issues relating to corporate governance and corporate control have come to the fore the world over in the recent past. The seeds of modern corporate governance were probably sown by the Watergate scandal in the USA. Subsequent investigations by US regulatory and legislative bodies highlighted control failures that had allowed several major corporations to make illegal political contributions and bribe government officials. While these developments in the US stimulated debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990s led shareholders and banks to worry about their investments. Several companies in UK which saw explosive growth in earnings in the '80s ended the decade in a memorably disastrous manner. Importantly, such spectacular corporate failures arose primarily out of poorly managed business practices.

This debate was driven partly by the subsequent enquiries into corporate governance (most notably the Cadbury Report) and partly by extensive changes in corporate structure. In May 1991, the London Stock Exchange set up a Committee under the chairmanship of Sir Arian Cadbury to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them. The Committee investigated accountability of the Board of Directors to

* Speech delivered by Shri V. Leeladhar, Deputy Governor, Reserve Bank of India on November 27, 2004 at the "Sheth Shantaram Mangesh Kulkarni Memorial Lecture" organised by The North Kanara G.S.B. Co-op Bank Ltd.

shareholders and to the society. It submitted its report and the associated 'code of best practices' in December 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability. Being a pioneering report on corporate governance, it would perhaps be in order to make a brief reference to its recommendations which are in the nature of guidelines relating to, among other things, the Board of Directors and Reporting & Control.

The Cadbury Report stipulated that the Board of Directors should meet regularly, retain full and effective control over the company and monitor the executive management. There should be a clearly accepted division of responsibilities at the head of the company which will ensure balance of power and authority so that no individual has unfettered powers of decision. The Board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands. There should also be an agreed procedure for Directors in the furtherance of their duties to take independent professional advice.

The Cadbury Report generated a lot of interest in India. The issue of corporate governance was studied in depth and dealt with by the Confederation of Indian Industries (CII), Associated Chamber of Commerce and Industry (ASSOCHAM) and Securities and Exchange Board of India (SEBI). These studies reinforced the Cadbury Report's focus on the crucial role of the Board and the need for it to observe a Code of Best Practices. Co-operative banks as corporate entities possess certain unique characteristics. Paradoxical as it may sound, evolution of co-operatives in India as peoples' organisations rather than business enterprises adopting professional managerial systems has hindered growth of professionalism in co-operatives and proved to be a neglected area in their evolution.

The Special Place of Banking

The banking sector is not necessarily totally corporate. Some part of it is, of course, but a segment of banks is mostly government owned as statutory corporations or run as cooperatives – just like your bank. Banking as a sector has been unique and the interests of other stake holders appear more important to it than in the case of non-banking and non-finance organisations. In the case of traditional manufacturing corporations, the issue has been that of safeguarding and maximising the shareholders' value. In the case of banking, the risk involved for depositors and the possibility of contagion assumes greater importance than that of consumers of manufactured products. Further, the involvement of government is discernibly higher in banks due to importance of stability of financial system and the larger interests of the public. Since the market control is not sufficient to ensure proper governance in banks, the government does see reason in regulating and controlling the nature of activities, the structure of bonds, the ownership pattern, capital adequacy norms, liquidity ratios, *etc.*

Reasons for High Degree of Oversight

There are three reasons for degree of government oversight in this sector.

- Firstly, it is believed that the depositors, particularly retail depositors, can not effectively protect themselves as they do not have adequate information, nor are they in a position to coordinate with each other.
- Secondly, bank assets are unusually opaque, and lack transparency as well as liquidity. This condition arises due to the fact that most bank loans, unlike other products and services, are usually customised and privately negotiated.
- Thirdly, it is believed that that there could be a contagion effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy. As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, resulting in a run on the deposits and putting the entire financial system in jeopardy.

Role of the Government and the Regulator

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

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

Board of Directors and their Committees:

At the initiative of the RBI, a consultative group, aimed at strengthening corporate governance in banks, headed by Dr. Ashok Ganguli was set up to review the supervisory role of Board of banks. The recommendations include the role and responsibility of independent non-executive directors, qualification and other eligibility criteria for appointment of non-executive directors, training the directors and keeping them current with the latest developments. Private sector banks, *etc.* it is unanimously accepted that the most crucial aspect of corporate governance is that the organisation have a professional board which can drive the organisation through its ability to perform its responsibility of meeting regularly, retaining full and effective control over the company and monitor the executive management. Some of the important recommendations on the constitution of the Board are:

- Qualification and other eligibility criteria for appointment of non-executive directors,
- Defining role and responsibilities of directors including the recommended "Deed of Covenant" to be executed by the bank and the directors in conduct of the board functions.
- Training the directors and keeping them abreast of the latest developments.

Measures Taken by Banks Towards Implementation of Best Practices

Prudential norms in terms of income recognition, asset classification, and capital adequacy have been well assimilated by the Indian banking system. In keeping with the international best practice, starting 31st March 2004, banks have adopted 90 days norm for classification of NPAs. Also, norms governing provisioning requirements in respect of doubtful assets have been made more stringent in a phased manner. Beginning 2005, banks will be required to set aside capital charge for market risk on their trading portfolio of government investments, which was earlier virtually exempt from market risk requirement.

Capital Adequacy: All the Indian banks barring one today are well above the stipulated benchmark of 9 per cent and remain in a state of preparedness to achieve the best standards of CRAR as soon as the new Basel 2 norms are made operational. In fact, as of 31st March 2004, banking system as a whole had a CRAR close to 13 per cent.

On the Income Recognition Front, there is complete uniformity now in the banking industry and the system therefore ensures responsibility and accountability on the part of the management in proper accounting of income as well as loan impairment.

ALM and Risk Management Practices – At the initiative of the regulators, banks were quickly required to address the need for Asset Liability Management followed by risk management practices. Both these are critical areas for an effective oversight by the Board and the senior management which are implemented by the Indian banking system on a tight time frame and the implementation review by RBI. These steps have enabled banks to understand, measure and anticipate the impact of the interest rate risk and liquidity risk, which in deregulated environment is gaining importance.

Measures Taken by Regulator Towards Corporate Governance

Reserve Bank of India has taken various steps furthering corporate governance in the Indian Banking System. These can broadly be classified into the following three categories:

a) Transparency

b) Off-site surveillance

c) Prompt corrective action

Transparency and disclosure standards are also important constituents of a sound corporate governance mechanism. Transparency and accounting standards in India have been enhanced to align with international best practices. However, there are many gaps in the disclosures in India vis-à-vis the international standards, particularly in the area of risk management strategies and risk parameters, risk concentrations, performance measures, component of capital structure, etc. Hence, the disclosure standards need to be further broad-based in consonance with improvements in the capability of market players to analyse the information objectively.

The off-site surveillance mechanism is also active in monitoring the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI also brings out the periodic data on “Peer Group Comparison” on critical ratios to maintain peer pressure for better performance and governance.

Prompt corrective action has been adopted by RBI as a part of core principles for effective banking supervision. As against a single trigger point based on capita adequacy normally adopted by many countries, Reserve Bank in keeping with Indian conditions have set two more trigger points namely Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability. These trigger points will enable the intervention of regulator through a set of mandatory action to stem further deterioration in the health of banks showing signs of weakness.

Conclusion

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