



# CORPORATE GOVERNANCE IN INDIAN BANKING SECTOR

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## Abstract

With the start of financial sector reforms in India during 1990's, the process of globalization and liberalization had started. The concept of corporate governance came into existence all across the globe during that time. Corporate governance in banking is different from other forms of business, as it deals with the money of investors and public at large and important to the economy. Banking has its linkages with the real sector and provides a payments and settlement system in the financial system of the economy. Therefore, Reserve Bank and the government has been continuously trying to improve the state of governance in banking sector by introducing specific Acts and set of guidelines / instructions issued time to time. Corporate governance practices need to be constantly evaluated due to uncertain and complex business environment. Corporate governance norms have primarily focused on the higher responsibility, accountability, transparency, quality, tighter regulation for the board of directors and the increase in shareholders' contribution. The aim of this paper is to provide an insight into the existing corporate governance practices in the banks in India. The present paper analyses the major corporate governance initiatives and guidelines provided by the RBI and other authorities with the areas of concerns.

**Keywords:** Corporate Governance, Board, Committees, Bank, Regulatory Bodies

## 1.1 Introduction

The efficient banking system is very important for development of the economy. The concept of Corporate Governance refers to a set of standards, whose purpose is to improve the organization's image, productivity, adequacy and overall moral responsibility. Corporate governance in banks helps to improve the transparency, integrity and accountability of the management of the organization. It covers many issues, such as Board of Directors issues and the matters related to the protection of investors' and public interests etc. According to N.R. NarayanaMurthy, Chairman, Committee on Corporate Governance, SEBI, "The term 'corporate governance' is susceptible both to broad and narrow definitions. In fact, many of the codes do not even attempt to articulate what is encompassed by the term. The important point is that corporate governance is a concept, rather than an individual instrument. It includes debate on the appropriate management and control structures of a company. Further it includes the rules relating to the power relations between owners, the board of directors, management and, last but not least, the stakeholders such as employees, suppliers, customers and the public at large."

## 1.2 Evolution

In India, financial Reforms of 1991 led to the entry of the private sector banks and foreign banks into the Indian banking industry. This resulted into the reduction of shareholding of the public sector banks. East Asian crisis also forced RBI to bring out stricter rules for corporate governance. Therefore, many advisory and consultative groups were formed to develop good corporate governance practices in India. The Organization for Economic Co-operation and Development (OECD), Principles on Corporate Governance, the first global initiative and the Basel norms provide the guidelines on corporate governance in the banks. Basel Norms refer to broad supervisory standards formulated by the Basel Committee on Banking Supervision (BCBS). The Basel committee framed the principles of governance for banks in 1999, known as Basil Accord I. This accord primarily focused on credit risk. RBI has the responsibility for enforcing the provisions related to credit risk in India. In 2004 came the Basel II which was based on the three pillars and aiming at developing a better risk management mechanism to monitor and manage all kinds of credit, market and operational risks. Basel III is a comprehensive set of reforms measures to strengthen the regulation, supervision and risk management, released in 2010 after the financial crisis of 2008. These guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity. RBI implemented these guidelines in phased manner.

Several initiatives were taken by government of India. In 1998, Confederation of Indian Industry (CII) launched the first voluntary code of corporate governance. In 1999, SEBI set up a Kumar Manglam Birla committee, which recommended clause 49 of the listing agreement of the stock exchanges. The committee had identified three key components as board of directors, management and stakeholders. The first announcement in regard to corporate governance was made in the year

2001 by the then RBI Governor- Dr. Bimal Jalan. An advisory group on corporate governance was constituted in March 2001. Dr. R.H. Patil was the chairman and the committee looked into issues relating to corporate governance in Indian banks and made recommendations to bring the governance standards in India at par with the best international standards such as the Basel norms and OECD Principles. In November 2001, a consultative group was formed and Dr. A.S. Ganguly was the chairman, with a view to strengthen the internal supervisory role of the boards of banks and its report was forwarded to all the banks and the government for consideration. In the year, 2002, Naresh Chandra committee was appointed by the Ministry of Finance and Company Affairs. This committee had recommended the two aspects of corporate governance i.e. financial disclosure and independent auditing. Subsequently, the advisory group on banking supervision under the chairmanship of Shri M.S. Verma also submitted its report in January 2003. Securities and Exchange Board of India (SEBI) had also taken another initiative by setting a committee under the chairmanship of Mr. N.R. Narayanamutrthy to review the clause 49. The committee's major recommendations were on independent directors, risk management, code of conduct, role of supervisors, effective organizational structure to have responsible board of directors, financial disclosures, audit reports and audit committees and ensuring an environment supportive to the sound corporate governance. In 2009, the Ministry of Corporate Affairs published the new set of guidelines for corporate governance with respect to auditors, audit committee, board of directors and responsibility of the board, secretarial audit and whistle blowing mechanism.

### 1.3 Reasons

The focus on corporate governance has become significant in India as banks are the important players of financial system and with globalization has come the competition. Today, banks face a more competitive and highly volatile global environment than other organizations. Banks provide finance to commercial enterprises and to the general public. They need to maintain also the reserve for statutory requirement to have sound capital structure. The transparency, accountability and integrity are principles of good corporate governance. The shareholders and potential investors require access to regular and reliable information to assess the management. A bank with good governance can offers the investors a safe place for investment and better returns. Therefore, good corporate governance in banks is important in retaining existing investors as well as attracting the new investors. The need of good corporate governance practices in banking sector is important in order to establish and maintain a capable and reliable board of directors and to manage effectively different committees such as audit committee, compensation committee and nomination committees etc. It is required to establish and maintain ethical codes and proper corporate governance procedures like internal control standards, disclosure standards and risk management. Corporate governance can be useful in providing the appropriate structure in the system by placing right objectives and goals in front of the organization and helping the organization to attain these goals, thus resulting in improved financial and operational performance.

## 1.4 Corporate Governance in Banking Sector

The corporate governance in banks is different and more important than other companies. The following are given some of the factors:

- A bank's main stakeholders are the depositors as a bank is a highly leveraged entity, unlike other companies where shareholders are the main stakeholders.
- A bank is an important player in the system as a participant in the payment and settlement systems and as a counterparty to other banks and non- bank corporations. A crisis in a bank spreads much faster within the system than a crisis in any other company.
- Banks are the main channel for the flow of credit in the financial system. The collapse of even a single bank can cause significant problems to its borrowers.
- A bank deals in large volumes of cash and non- cash substitutes and has a vast geographical presence and that makes it relatively difficult to control operations and so exposes it to frauds.
- A bank deals with complex financial products and the risks related to these products are difficult to identify and measure.
- Technology is being increasingly used in the field of banking. On the one side, it improves the operating efficiency of banks but on the other side, it exposes to a higher possibility of fraud.
- Process outsourcing is an increasing reality in the field of banking which leaves it with much less control over the systems and processes.

The fact that there is high degree of corporate governance that needs to be ensured in case of banking Institutions as compared to any other corporation and hence corporate governance regulations have been introduced in banking Industry in India.

## 1.5 Legal Framework

Corporate Governance is among the wide ranging powers of Reserve Bank of India (RBI) to regulate the financial sector provided by the Banking Regulation Act, 1949. Corporate Governance mechanism of RBI follows a three-pronged approach, prompt disclosure and transparency norms, off- site surveillance and timely appropriate corrective action. RBI performs the corporate governance function under the Board for Financial Supervision (BFS) who inspects and monitors the banks through its CAMELS approach i.e. capital adequacy, asset quality, management, earnings, liquidity, and sensitivity. BFS was constituted in November 1994, as a committee of the central board of directors of the Reserve Bank under the Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with a primary objective of undertaking consolidated supervision of the financial sector comprising Scheduled Commercial and Co-operative Banks, All India Financial Institutions, Local Area Banks, Small Finance Banks, Payments Banks, Credit Information Companies, Non-Banking Finance Companies and Primary Dealers. Along with providing guidance

to the RBI, Board of Financial Supervision also looks after the Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS) and the Financial Institution Division (FID), in terms of issuing necessary directions for important regulatory matters.

RBI and the Government of India play a direct role in bank governance through bank regulations and supervision. The current regulatory framework gives almost the same treatment to private banks and public sector banks. However, it is the primary responsibility of the bank to develop sound corporate governance practices for itself as these regulatory agencies only lay external pressure on the banks through rules and regulations. The banks also have to take part actively by establishing an internal governance mechanism. Internal corporate governance is about mechanism for the accountability, monitoring, and control of the management with respect to the use of resources and risk taking. The Board of Directors and the senior management and the various committees together have to come up with policies that are in accordance with the legislative framework and the guidelines provided from time to time vide notifications issued by the RBI.

### 1.6 RBI's Initiatives

The Banking Sector in India has adopted and incorporated some of the developments occurring across the world with regard to corporate governance. Numbers of steps have been taken by the RBI to enhance the usefulness of corporate governance in banks and following are some of them:

- RBI issues licenses to more banks now;
- More independence is given to boards of public sector banks;
- The more number of independent directors are appointed to increase the professionalism on boards of public sector banks;
- The coverage, timing and analytical content of information has been expanded to ensure better transparency;
- Emphasis has been laid on deregulation and operational freedom to achieve the operational transparency;
- Information Help Desks in central and regional Offices are proposed to be set up to which the common person may approach offline or online;
- Compensation structures for key management personnel and whole-time directors is revised;
- Now banks need to disclose the actual Non Performing Assets (NPAs) so that the problem of NPAs can be addressed;
- The "Corporate Governance Reforms 2.0" is the recent initiative taken by the RBI. The key proposals of these reforms are like more professionals should come in risk management, information technology and human resource management, audit committee should be independent of any influences, a nomination and remuneration committee (NRC) should be set up in banks, along the lines suggested by the Companies Act, 2013 etc.



## 1.7 Concerns related to Corporate Governance in Indian Banking Sector

The financial position of the banks across the country had shaken at the time of announcement of demonetization by the government on 8th November, 2016. It swayed the banking sector completely, changing the functioning of the banks, their products as well as the services provided by them. The bad loan ratio for agriculture loans had risen sharply. The merger of the banks followed as they were facing credit problems. Credit and deposit growth in banks remained slow. High volumes of non-performing assets (NPAs) in banks had eroded their capital base and restricted their ability to lend. After this slowdown of the country's economy, the Covid-19 crisis have shaken the banking sector in India. Economic activities of the country have come to a halt due to complete lockdown in the previous years. A sharp deceleration in the manufacturing activities and a keen deterioration in business conditions are noted. A portion of the total finance available with the banks is being used to fight the Covid-19 situation in the country as the financial crisis is on the rise. The companies and the individual borrowers are still not in a position to repay the loans and banks remain highly risk averse.

## 1.8 Conclusion and Suggestions

The financial position of the banks in recent past has not been so good. Other than the outside factors, it can be attributed to the poor risk management systems and non-compliance with disclosure requirements also i.e., lack of good governance practices in the banking system in the country. The guidelines has been issued time to time but non-compliance of them is the major issue. In the midst of the economic slowdown in the country we still somehow managed to attain financial stability in banks, controlled the NPAs to some extent but the recent corona virus pandemic situation is likely to hit the economy again and paralyzing the banking sector. The following are some suggestions:

- A well-formed strategy is required for the authorities seeking to improve governance in banking.
- It is required to reduce the opacity of banks by improving the flow of information to all the concerned stakeholders.
- The improvement in the credit information will facilitate the expansion of banking, as those interested in providing finance to groups that were previously excluded.
- Enhancing corporate finance reporting in the media as well as education regarding the importance of this issue in the society will help.
- Opening to foreign banks offers a direct mechanism for creating competitive pressures in banking in general and it will also improve access to credit, even by small and medium-sized enterprises.
- The potential monitors of banks like owners, markets (large creditors) and supervisors, they need clear and strong incentives to do their jobs well.
- The ability of authorities to influence inside owners and managers is enhanced if regulators can impose penalties when there is evidence of fraud or improper conduct.

- Compensation policies of directors and senior managers demand greater attention though some steps have been taken in this regard already.
- To improve corporate governance of financial intermediaries, policy makers must seek to enhance the ability and incentives of creditors and other market participants to monitor banks.
- The focus should be more on compliance and implementation. Starting from the board level, there is a need for banks to follow the RBI's instructions and guidelines.

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