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CORPORATE GOVERNANCE IN BANKING SECTOR : NATIONAL AND INTERNATIONAL PERSPECTIVE

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Abstract

This paper examines the ongoing initiatives at the international as well as at the national level, with special reference to India, to implement corporate governance in the banking sector. This paper is presented in four sections. Section I explains the concept of corporate governance. Section II provides the efforts made at the international level to implement the corporate governance. Section III ends with the conclusion of the paper.

PART – I

Corporate governance is the current buzzword in India as well as the world over. Corporate governance has been triggered by a crisis in the financial sector and the consequent suffering of citizens. In the case of Indonesia, which was hit hardest during the Asian financial crisis, the fiscal costs alone of government stepping in to make good on the obligations of the privately held banks exceeded 100 per cent of the Indonesian Gross Domestic Product (GDP). Financial crisis typically entails a large social and economic cost which visited not only the wealthy who have something to lose but also the population of countries when employment dwindled and wages collapsed as GDP dropped sharply and currency values plummeted.

Corporate Governance was talked about in an organized manner in 1990s. The movement gained further impetus with most of the progressive economies of the world opting for an economic policy of Deregulation, Liberalization, Privatization and Integration with most of the world economies based on the principles of cost advantage. The dismantling of the iron walls between iron curtain countries and gradual opening up of the western economies, unification of the centrally planned economies like China and India, formation of bigger West European market by eight rich Euro countries in nineties, disintegration of the Union of Soviet Socialist Republic (USSR) into several smaller independent countries were the hall mark of changing social, economic and political scenarios of the post 1980s.

Need for Corporate Governance in India

Even in countries where regulatory mechanisms are more demanding in their content and more vigilant in their implementation, flagrant violations under the veil of corporate impenetrability have generated a strident demand for better governance. The advent of the information age has created an awakened shareholder, vigilant public and almost predatory journalistic fervour. Depending upon the model of corporate disclosure followed by different legal frameworks, the right to information has forced corporates to divulge more than they ever did. In India, the question of corporate governance has come up mainly in the wake of economic liberalization and deregulation of industry and business as well as the demand for a new corporate ethos and stricter compliance with the law of the land. In the context of the unique situation in India where the financial institutions hold substantial stakes in companies, the accountability of directors, including non-executives and nominees, has come into sharp focus.

Another aspect relates to the reform process initiated since 1991-92. In the pre-reform period, most decisions were taken externally. But recently, there has been a movement away from micro regulation by the RBI. There is thus a shift from external regulation to the internal system and therefore, the quality of the corporate governance within the bank or financial institution becomes critical in the performance of the financial sector and indeed the growth of the financial sector.

PART - II

Corporate Governance in the Banking Sector:

International Perspective

At the global level, the importance of the banking and financial sector in macro-economic stability has been highlighted after the Asian crisis. In other words, in the integrating markets, systemic risks can flow from national to regional and international levels. Hence the IMF has reiterated the criticality of governance in ensuring macro-economic stability, confidence and growth.

The World Bank's Global Corporate Governance Forum has developed a framework for action that connects the policy structures with the corporate (both public and private) and provides the scope for a multi-prolonged approach to regulatory and private voluntary action. It emphasises the critical need for balancing the traditional theories with the new market structures and the need to harmonise divergent interests, players, models and markets. Both the World Bank Group and the IMF have articulated the critical role of corporate governance at the micro and macro environmental levels and have been in the forefront of several initiatives, some in close collaboration with OECD and the commonwealth secretariat.

The IMF approach to corporate governance of banks, as evident in its publications, asserts that :

(i) The soundness of a bank is first and foremost the responsibility of its owners and managers and yet the soundness of a banking system is a public policy concern also;

(ii) Bank soundness is crucially linked to sound macro-economic policies;

(iii) A framework for sound banks must include structures to support internal governance and market discipline as well as official regulation and supervision; and

(iv) International cooperation and coordination can play an important role not only in strengthening the global financial system but also in improving the soundness of national banking systems.

The IMF has announced a code of good practices in fiscal transparency and also on transparency in monetary and financial policies. The code on fiscal transparency addresses several issues that are of particular importance to developing countries and is based around four key objectives, viz.,

(i) Clarity in roles and responsibilities of government;

(ii) Public availability of information on government activities;

(iii) Transparency in budget preparation, execution and reporting, and

(iv) Integrity in fiscal information to be scrutinized by an independent authority.

Organisation for Economic Cooperation and Development (OECD) Principles Of Corporate Governance

The OECD Council, meeting at ministerial level on 27-28 April 1998, called upon the OECD to develop, in conjunction with national governments, other relevant international organizations and the private sector, a set of corporate governance standards and guidelines. The following are the Principles of Corporate Governance:

1. The rights of shareholders

The corporate governance framework should protect shareholders' rights:

A. Basic shareholder rights include the right to:

(1) secure methods of ownership registration;

(2) convey or transfer shares;

(3) obtain relevant information on the corporation on a timely and regular basis;

(4) participate and vote in general shareholder meetings;

(5) elect members of the board; and

(6) Share in the profits of the corporation.

B. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

(1) amendments to the statutes, or articles of incorporation or similar governing documents of the company;

(2) the authorization of additional shares; and

(3) extraordinary transactions that may result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholders meetings and should be informed of the rules, including voting procedures, that govern general shareholders meeting:

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

F. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

2. Equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redressal for violation of their rights.

A. All shareholders of the same class should be treated equally.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

3. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co - operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

4. Disclosure and Transparency

A. Disclosure should include but not be limited to, material information on:

(i) The financial and operating results of the company.

(ii) Company objectives.

(iii) Major share ownership and voting rights.

(iv) Members of the board and key executives, and their remuneration.

(v) Material foreseeable risk factors.

(vi) Material issues regarding employees and other stakeholders.

(vii) Governance structure and policies.

B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

C. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way financial statements have been prepared and presented.

D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

5. The Responsibilities of the Board.

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. The board should ensure compliance with applicable law and take into account the interests of stakeholders.

Basle Core Principles :

Among the international efforts, the contribution of the Bank for International Settlements (BIS) – particularly the Basle Committee on Banking Supervision, the International Organization of Securities Commissions, the International Association of Insurance supervisors, the Group-10 Deputies are notable.

The Basle Committee on Banking Supervision is a Committee of Banking Supervisory Authorities which was established by the Central Bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and Central Banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

(i) The Basel Committee has issued set of papers which include, 'Principles for the managements of interest rate risk (September 1997), "Framework for internal control systems in banking organizations" (September 1998), 'Enhancing bank transparency' (September 1998), and 'Principles for the management of credit risk' (July 1999).

Advisory Group on Banking Supervision

The importance of corporate governance in banks was emphasized by the Advisory Group on Banking Supervision (Chairman: Shri M.S.Verma) as well as the Banking Supervision and Advisory Group on Corporate Governance (Chairman: Dr. R.H.Patil) in the overall context of companies.

The Non-Official Advisory Group on Banking Supervision was appointed in 2000 by the Standing Committee on International Financial Standards and Codes (Chairman Dr. Y.V.Reddy) under the chairmanship of Mr. M.S.Verma. The Advisory Group went into various aspects of this issue and submitted its report in March, 2001.

The Advisory Group examined different papers brought out by the Basle Committee on Banking Supervision. The Advisory Committee has made several recommendations which relate to seven major areas like

1. Core Principles
2. Corporate Governance
3. Internal Controls
4. Credit risk
5. Loan accounting
6. Transparency and disclosures
7. Financial conglomerates and cross border banking

The group concluded that given the level of complexity and development of the Indian Banking Sector, the level of compliance with standards and codes is of a high order.

The following are the important recommendations of the Consultative Group of Directors of Banks and Financial Institutions.

(1) Due diligence is a must while selecting men for appointment on Board of Directors of Banks.

(2) Government should follow some norms like BIS for judging the suitability of directors for appointment on Board of Directors of Public Sector Banks.

(3) For assessing integrity and suitability factors, criminal information furnished to the Board should be wholesome, complete, and adequate to take meaningful decisions. A distinction needs to be made between statutory items and strategic issues in order to make the material for directors "manageable." The manner in which the Board Proceedings are recorded and followed up in public sector banks leaves much scope for improvement. The Reviews dealing with various performance areas could be put up to the supervisory committee of the board and a summary of each such review could be put up to the Main Board. The Board's focus should be devoted more on strategy issues, risk profile, internal control systems, overall performance of the bank etc.

(4) The procedure followed for recording of the minutes of the Board meetings in banks and financial institutions should be uniform and formalized. It has been mentioned that there should be two ways of doing it.

a) a summary of key observations and

b) a more detailed recording of the proceedings. It has been also suggested that in every meeting, the board should review the action taken on the points arising from earlier meetings and till action is completed to its satisfaction, the pending items should continue to be put before the board.

(5) it would be desirable if the exposures of a bank to stock brokers and market makers as a group, as also exposures to other sensitive sectors like real estate, capital market etc. are reported to the Board regularly. The disclosures in respect of the progress made in putting in place a progressive risk management system, the risk management policy, strategy followed by the bank, exposures to related entities, the asset classification of such lending / investment etc, conformity with corporate governance standards etc. be made by banks to the Board of Directors at regular intervals as prescribed.

(6) All banks should consider appointing a company secretary as the secretary to the Board and have a Compliance Officer (reporting to the secretary) for monitoring and reporting compliance with various regulatory/accounting requirements.

(7) There could be a Supervisory Committee of the Board in all banks, public or private, which will work on collective trust and at the same time, without diluting the overall responsibility of the Board. This committee would look into the matter of

a) monitoring the exposures (credit and investment)

b) review of the adequacy of risk management process and upgradation thereof,

c) internal control system

d) ensuring compliance with the statutory/ regulatory framework.

(8) The committee opined that the Audit Committee should ideally be constituted with independent/ non executive directors and the executive directors should only be permanent invitees. In the case of public sector banks, the existing arrangement of including the executive director and nominee directors and the RBI in the Audit Committee may be allowed to continue.

(9) The committee is of the opinion that the Chairman of the Audit Committee need not be a CA but he must be a man of knowledge on finance and banking. He

should be able to provide directions and guidelines to the Audit Committee in the context of accounting issues and overall management of the bank.

(10) The committee is of the opinion that a Nomination Committee of the Board should be appointed with a view to nominating independent/non executive directors of banks as well as nomination of directors representing shareholders.

(11) The committee is of the opinion that with a view to building credibility among the investor class, the Board may set up a Committee of the Board to deal with grievances of investors/ shareholders. The Company Secretary would be the nodal point for such a committee.

(12) The formation and operationalisation of the Risk Management Committees in pursuance of the guidelines issued by the RBI should be speeded up and their role is to be strengthened further.

(13) Banks should create a strategy plan for implementation of the governance standards and submit periodical progress report to record the progress of banks in this context.

PART – III

Conclusion

To sum up , the objective of governance in banks should first be protection of depositors' interests and to "optimize" interests. All other considerations would fall in place once these two are achieved. Peter Drucker in his book calls optimization "maximizing the wealth-producing capacity of the enterprise". The author would like to record that the goal should be to maximize the wealth of shareholders over a fairly long period of 3 to 5 years without incurring losses even in the short term of a financial year.

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