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CORPORATE GOVERNANCE OF BANKS

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Abstract: *Corporate governance is an important aspect of managing the corporate form of the organizations. Of late it has assumed greater significance and researchers, practitioners and policy makers have been exploring ways in which modern corporation should be managed to meet the economic, social and legal needs of different socio-political systems. Different bodies in different countries has studied the issue of corporate governance and recommended the ways in which corporate should be managed. They have highlighted the issues like shareholder protection, transparency, reporting, related party transactions etc. Means through which they wish to achieve desired objectives are board structure, shareholding patterns, role of gate keepers, CEO remuneration, and external market for corporate control etc. Of late researchers realized that the governance of bank is different as compared to other forms of corporate organizations. This paper attempts to understand this difference of corporate governance at banks and attempts made by different bodies to improve the corporate governance at banks. A special emphasis has been made to understand this issue for Indian banks.*

Index terms: Corporate governance, Banks, Indian banks, Corporate governance of Indian banks.

1. INTRODUCTION

Corporate governance (CG), as the name signals, is an integral and indispensable constituent of the 'corporate' form of organization. Therefore, before attempting to understand corporate governance and corporate governance of banks, it is necessary to understand a corporate structure. Unique Characteristics of a corporate form of organization are:

- Distinct Legal Entity: A corporate body created by the law is an entity which is legally distinct from individuals (who put their share corpus in it) and has perpetual existence. It has the capacity to own assets, act on its own and bear liability for its actions.
- Separation of Ownership and Management: There is a distinction between those who have ownership of the company and those who control its affairs. The management runs the operations of the company without being individually responsible for providing finance.
- Limited Liabilities of the Members: Limited liability with respect to share ownership confers an attractive option for risk-averse investors who want to be part of the organization through their investment in share capital.
- Ease of Transferability of Ownership: A shareholder can easily pass the risk of ownership to others if he perceives that stocks of the company may lose value.

2. NEED OF CORPORATE GOVERNANCE

Underlying need of corporate governance dates back to the emergence of companies. Adam Smith was the first to highlight the need of corporate governance.

The separation of ownership and control in large companies with fragmented ownership, poses governance problems. Investors in public companies face the challenge of ensuring efficient utilization of their funds by managers for creation of wealth. Corporate Governance has evolved due to this separation between ownership and management with a view to solve governance problems in joint stock companies.

The extent and scope of corporate governance is vast and spans multiple disciplines. Due to such pluralism of corporate governance, its definition varies among scholars and researchers according to the perspective that they view the subject with. Corporate governance can be generally defined as the system by which companies are directed and controlled. One of the earliest Definition of Corporate Governance is given by Cadbury Committee.

The system by which companies are directed and controlled. The Board of Directors is primarily responsible for governance of the company. The shareholder, on the other hand, is just there to appoint the directors and auditors and assure that a governance structure is in its place in the company.
Cadbury report (1992, para. 2.5)

3. CORPORATE GOVERNANCE OF BANKS

Corporate governance of banks is different from corporate governance of ordinary companies. This is due to the nature of the banking business, the complexity of the organisation, the uniqueness of banks' balance sheets, the need for protection of the weakest party in the chain (i.e., the depositors) and the systemic implications that a bank failure can have.

The balance sheet of a bank may sometimes have a greater degree of opacity compared to its corporate peers; it is difficult for outsiders to evaluate the quality of the assets which a bank holds and, therefore, its true financial position. Further, a bank serves several conflicting interests, from equity holders, to borrowers or depositors and good governance is important for balancing those interests.

Finally, the potential negative externalities of bank failures are very damaging for the economy and for society, as was demonstrated vividly by the global financial crisis. In this respect, it is now acknowledged that corporate governance of banks should be addressed with specific recommendations, focusing on "internal governance", strategic and oversight responsibilities of the board and risk management rather than on protection of minority shareholders. Realizing this need Basel Committee on Banking Supervision provided thirteen Principles for

Corporate Governance in Banks in 2015. These principles are comprehensive and provide good guidance for corporate governance in banks. Following are the Principles as suggested by Basel Committee:

Principle 1: Board's overall responsibilities: The board has overall responsibility for the bank, including approving and overseeing management's implementation of the bank's strategic objectives, governance framework and corporate culture.

Principle 2: Board qualifications and composition: Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.

Principle 3: Board's own structure and practices: The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Principle 4: Senior management: Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.

Principle 5: Governance of group structures: In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business and risks of the group and its entities.21 The board and senior management should know and understand the bank group's organisational structure and the risks that it poses.

Principle 6: Risk management function: Banks should have an effective independent risk management function, under the direction of a chief risk officer (CRO), with sufficient stature, independence, resources and access to the board.

Principle 7: Risk identification, monitoring and controlling: Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

Principle 8: Risk communication: An effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Principle 9: Compliance: The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.

Principle 10: Internal audit: The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank.

Principle 11: Compensation: The bank's remuneration structure should support sound corporate governance and risk management.

Principle 12: Disclosure and transparency: The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Principle 13: The role of supervisors: Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

The way in which banks fund their operations means that in comparison to other companies, corporate governance of banks aims to provide protection to a much broader pool of stakeholders, in particular depositors which usually do not have the possibility to influence the banks' business decisions. This requires a much deeper involvement of the board in strategic issues and risk oversight, as it must fully understand the risks the bank is exposed to and be able to monitor them effectively. Consequently, requirements for balance of skills at the board and the expertise of its members are regulated in detail and closely scrutinized by bank supervisors.

Further, there is greater emphasis and more detailed guidance on the internal control functions of the so called "second and third line of defense" – i.e. risk management, compliance and internal audit, which are becoming mandatory for banks in an increasing number of jurisdictions. Due to many traditional and emerging risks inherent to the banking business, which are both financial (e.g. credit, market and interest rate risks) and non- financial (e.g., operational, conduct, cyber security) in nature, banks are now expected to develop risk appetite frameworks that will help them to control better the aggregate amounts of those risks they are taking in pursuit of their strategy. Banks are also subject to stricter disclosure requirements.

There is no one who could deny the fact banks are pivotal to the economic stability of any economy. In case a bank crashes then it does not crash alone, it also takes away the lifelong investment and savings of its entire account holders too. This is not the only reason due to which corporate governance in the banking sector is needed. Corporate Governance is also needed for the bank to keep a check on money laundering, financing immoral and criminal acts and transaction of money to the terrorists. In recent years, standard-setting bodies such as the Basel Committee for Banking Supervision ("BCBS"), Financial Stability Board ("FSB") and European Banking Authority ("EBA") have taken significant efforts to address the weak corporate governance practices of banks. Some of the key standards and guidelines can be found on the links below:

- Corporate Governance Principles for Banks (BCBS, 2015),
- External Audits of Banks (BCBS, 2014),
- The Internal Audit Function in Banks (BCBS, 2013),
- Compliance and the Compliance Function in Banks (BCBS, 2005),
- Principles for an Effective Risk Appetite Framework (FSB, 2013),
- Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture (FSB, 2014)

- Principles for Sound Compensation Practices (FSB/FSF, 2009),
- Guidelines on Internal Governance under Directive 2013/36/EU (EBA, 2017),
- Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU (EBA and ESMA 2017),
- Guidelines on sound remuneration policies (EBA, 2015)

4. RESERVE BANK OF INDIA AND CORPORATE GOVERNANCE IN THE BANKING SECTOR IN INDIA

In India, the Reserve Bank of India ("RBI") is the gatekeeper of Corporate Governance. RBI is the central bank of India which regulates all the major issues related to currency, foreign exchange reserves etc. In short, RBI is the bank responsible for securing the monetary stability in India

The preamble of the Reserve Bank of India Act, 1934 says, "An Act to constitute a Reserve Bank of India. Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency any credit system of the country to its advantage; And whereas in the present dis-organization of the monetary systems of the world it is not possible to determine what will be suitable as a permanent basis for the Indian monetary system; But whereas it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures…"

RBI in India plays leading role in formulating and implementing corporate governance. The corporate governance mechanism as followed by Reserve Bank of India is based on three categories for governing the banks. They are:

(i) Disclosure and transparency,
(ii) Off-site surveillance,
(iii) Prompt Corrective Action.

Disclosure and transparency: Disclosure and transparency is the most important constituent of corporate governance. If the banks will not be disclosing their transactions to the RBI then they can operate at their whims and fancies and may vanish with the lifelong investments and savings of the people. The RBI through the requirement of routine reporting of financial transactions of the bank keeps a tab on the activities being undertaken by the banks in India. Any failure to abide by the requirements set out by RBI may lead to heavy fines being imposed along with the cancellation of the license to operate as a bank. Most recently cases of RBI imposing penalty are the imposition of penalty on Devi Gayatri Co-operative Urban Bank Ltd., Hyderabad, Telangana, while exercising the powers vested in it under the provisions of Section 47A (1) (b) read with Section 46 (4) of the Banking Regulation Act, 1949 (As

Applicable to Co-operative Societies), for violation of Reserve Bank of India directives and guidelines on loans and advances to directors and their relatives, on Credit Agricole Corporate and Investment Bank, India and The TumkurVeerashaiva Co-operative Bank Ltd.,Tumkur, Karnataka.

Off-site surveillance: RBI routinely perform an annual on-site inspection of the records of the banks but in order to promote governance in banking sector RBI in the year 1995, off-site surveillance function was initiated in 1995 for domestic operations of banks. The main focus of the off-site surveillance is to monitor the financial health of banks between two on-site inspections, identifying banks which show financial deterioration and would be a source for supervisory concerns. The off-site surveillance prepares RBI to take timely remedial action before things get out of control. During December 1995 the first tranche of off-site returns was introduced with five quarterly returns for all commercial banks operating in India and two half yearly returns one each on connected and related lending and profile of ownership, control and management of domestic banks. The second tranche of four quarterly returns for monitoring asset-liability management covering liquidity and interest rate risk for domestic currency and foreign currencies were introduced since June 1999. The Reserve Bank intends to reduce this periodicity with effect from April 1, 2000.

Prompt Corrective Action: RBI while promoting corporate governance in banks in India has RBI has set trigger points on the basis of CRAR, NPA and ROA. On the basis of trigger points set by RBI, the banks have to follow 'structured action plan also called mandatory action plan'. Beside mandatory action plan RBI has discretionary action plans too. The main reason for classifying the rule-based action points into Mandatory and Discretionary is that some of the actions are essential to restore the financial health of banks must be mandatorily taken by the bank while other actions will be taken at the discretion of RBI depending upon the profile of each bank.

5. Conclusion

The special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. Corporate governance in the banking sector is not just a formality but a dire need of society. In almost every country in the world, there is a watchdog like RBI which monitors all the transactions and activities undertaken by the banks and regulate the business of the bank by making them submit regular reports related to the business undertaken by them.

However, too much pressure on the banks must not be imposed on the banks in the name of corporate governance so much so that they feel harassed in the name of governance and their efficiency suffers leading to a slowdown of financial transactions. Additionally, internal governance must be increased which must be formulated in a way that the efficiency of banks is not.

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