

Corporate Governance - An Agenda for Public Sector Banks

R. G. Gadkari *

Banking operations worldwide have been undergoing a fundamental change in the last two decades. Financial liberalisation and technical change have created new and complex financial products and have increased their turnover in financial markets. The benefits of these developments have been substantial, but they have also brought in their wake more risks. The banking crisis episodes in Latin America and SouthEast Asia bear a testimony to this. At the root of these crises is the collective myopia of members of banks, boards, supervisors, external auditors and institutional shareholders. Had they been more vigilant, the crises could perhaps have been avoided or their severity could have been restricted.

There are lessons from this for the Indian financial system in general and Public Sector Banks (PSBs) in particular. With phased deregulation of markets, increasing competition and growing globalisation of the Indian economy, the turf on which the PSBs operate is turning more complex and the business environment more turbulent. For their growing capital needs, the PSBs would have to approach retail and institutional investors frequently as the budgetary support from the Government is being progressively reduced and would eventually be phased out. Some PSBs also plan to tap the GDR/ADR markets for raising global resources.

As the ownership of the PSBs gets broad-based, the external constituencies of institutional and individual shareholders would be increasingly more important for PSBs. The secondary market price of their shares will depend on the quality of governance, vision of the board, its ability to face and pre-empt crises and key performance indicators such as EPS, RoA, RoE and EVA,

In such a scenario; the functioning of the boards of PSBs needs to undergo a qualitative change if they are to meet the expectations of external constituencies. There has to be increasing synergy between executive and non-executive directors. Institutional shareholders and external auditors. A way to ensure this is to have a formal ode for corporate governance in place. Such a code would state the responsibilities and rights of the members of the board and their relationship with the other functionaries. Being a document of self-discipline, it would be free from bureaucratic controls and flexible enough to undergo a change as and when warranted.

Corporate Governance: What does the term mean?

The term corporate governance' is not well defined. It includes the policies and practices adopted by a corporate entity in achieving its objectives in relation to its stakeholders. It prescribes a code of corporate conduct in a normative sense in relation to all stakeholders, external and internal. The essence of corporate Governance is a framework of effective

accountability to Corporate governance is thus an instrument for benefiting all stakeholders of a corporate entity. It entails driving the corporation's strategy and overseeing the day-to-day business within each process, through creation of checks and balances. In its widest sense, corporate governance is almost akin to a trusteeship. It is about creating an outperforming organisation, which leads to increasing customer satisfaction and shareholder value. It helps to create a corporate culture of conscience and consciousness, transparency and openness. The philosophy behind corporate governance is that the Board of Directors should not confine itself to statutory functions alone but become an effective pivot ensuring direction and management. Employees must not only feel empowered to take risks, but also be made aware of the accompanying responsibilities. This is the essence of corporate governance.

Code for Corporate Governance

At the heart of the corporate governance is the Code of Best Practices designed to achieve the necessary high standards of corporate behaviour. The various codes of conduct that have been prescribed across the world are expressions of good practices developed and practiced by the corporations with sustained success.

The history of these codes shows that they were formulated, by and large, as reactions to corporate disasters. In

* Assistant General Manager, State Bank of India, Economic Research Department, General Office Mumbai
Paper presented for the Bank Economists Conference held at Bangalore.

the UK, for instance, a spate of corporate failures of the early 1990s led to the setting up of a Committee under the chairmanship of Sir Adrian Cadbury to consider the financial aspects of corporate governance. Good financial governance, it was felt, would prevent unexpected company failures and cases of fraud. The Code of Best Practice designed by the Committee has been accepted by the London Stock Exchange and all the listed companies in the UK have to state as a continuing obligation of listing, whether they are complying with the code and if not, why not.

A code for corporate governance for public sector banks in India, likewise would enable the boards of these banks to maximise both the shareholder value and customer satisfaction. It could be in the form of a set of prescriptions and proscriptions for the key decision-makers of a bank – its chairman, executive and non-executive directors, institutional investors and external auditors. Such a code, it is believed, would enable the boards of the banks to resolve a conflict of interests between shareholders, customers, employees and other stakeholders. It would galvanise the board into an effective decision-making body and would give a sense of direction to the whole organisation. An informed debate on the issues of contemporary banking in the boardrooms would help develop the vision to anticipate crises and the will to act pre-emptively.

The code would, in brief, be a charter of empowerment for the board of directors along with the attendant responsibilities and obligations.

A suggested Code of Best Practice for PSBs

In the following paragraphs an attempt is made at framing a code of best practice which may be followed by the public sector banks in India. It can also be made applicable *mutatis mutandis*, to the boards of private sector banks operating in India.

At the outset, it needs to be stressed that the banking business is different from other forms of business in some important aspects. Banks provide a payments and settlement system to the economy and have important linkages with the real sector. It is for these reasons that bank all over the world are subject to a higher degree of regulation, than other enterprises. In addition the public sector banks, being owned partly or wholly by the Government of India, the Government has a stake in the profitable and should functioning of the PSBs.

Openness, integrity and accountability must be the key elements of corporate governance for any corporate entity. These factors assume greater importance in case of PSBs for reasons stated above. It is, therefore, necessary that the board of directors, external auditors and supervisors of a public sector bank strive to achieve greater degree for openness, transparency, integrity and accountability in the working of the institution.

The Changing Role of the Board of Directors

In the era of deregulation and greater autonomy for PSBs, the board of directors of a PSB has a very formidable task to perform. It has to steer the bank through turbulent times, take vital decisions on pricing of products, and develop corporate strategies for managing various risks and meeting challenges posed by competitors. It has to formulate and implement investment policy for the bank. The board members also need to develop vision to anticipate crises and possess the will to act preemptively.

Widespread ownership of PSBs which have offered their shares to the public would make it necessary to ensure that shareholders have adequate representation on the board through non-executive directors. The Board would thus consist of Chairman, Managing Director other executive directors and non-executive directors representing the shareholders. The non-executive direc-

tors would be in the best position to monitor the performance of the board and that of the chief executive. A senior non-executive director should take the lead to maintaining the balance between the executive and non-executive directors. He should ensure that the chairman, who is an executive director in case of PSBs, is aware of the views of non-executive directors.

The Chairman

The role of the chairman in corporate governance is fundamental. He is the *primus inter pares* the first among equals and has to play this role effectively. The Chairman has to ensure that the collective ability of the board provides both the leadership and the checks and balances which effective governance demands. It is also for the Chairman to make certain that the non-executive directors receive timely and relevant information tailored to their needs and they are briefed on the issues arising at meetings in order to make them effective board members. A bifurcation of the roles of the Chairman and the Managing Director is necessary to ensure that the Chairman is free from operational chores and is able to give focussed attention to the working of the board.

Non-Executive Directors

The independent non-executive directors will have to play an increasingly important role as representatives of shareholders and other stakeholders in overseeing the performance of executive directors. In view of their diverse background, qualifications and experience, there is a need for their proper induction into the bank's board. They should be imparted internal or external training in matters of banking, which would cover banking law, regulatory requirements and current trends in global banking. Newly appointed board members, including workman director and director representing officers' association, should go

through a proper process of induction into the bank's affairs. Thereby, the individual directors would be able to keep themselves abreast of their statutory and broader responsibilities. With the support of the Reserve Bank of India, National Institute of Bank Management and Indian Banks' Association, a course covering the full range of board responsibilities to trends in contemporary banking needs to be arranged periodically for non-executive bank directors.

In matters vital to the interest of the bank, for example a key investment decision or a decision to diversify into an uncharted territory or negotiation with the employees' representatives, it is likely that the non-executive directors may not have desired expertise. In such cases, it is suggested that they may be permitted to take independent professional advice, for which an agreed procedure should be established.

The Reserve Bank of India has directed banks to set up Audit Committees of the Board chaired by a non-executive director and consisting of non-executive directors. The Audit Committee is charged with the responsibility of ensuring the efficacy of the entire internal control and audit functions in the bank besides compliance with the inspection reports of the Reserve Bank and internal and concurrent auditors. It is suggested that the chairman of the audit committee should be responsible for answering questions at the bank's Annual General Meeting.

Institutional Shareholders

Of late, institutional shareholders (which term includes the UTI, mutual funds, LIC, GIC and FIs) have emerged as major stakeholders of quoted companies. They are, however, largely holding their shares on behalf of individuals as members of mutual funds, pension funds, holders of insurance policies and so on. As a result, there is an important degree of commonality of interest between individual and institutional sharehold-

ers. However, given the size of their holding institutional investors have the capacity of influence the standards of corporate governance. Institutional investors should, therefore, encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management. They can play a significant role in the appointment of non-executive directors for the necessary calibre, experience and independence.

External Auditors

The liability and legal duty of the external auditors is only to the company and to shareholders collectively, but not to individual shareholders or to third parties like depositors. Further, auditors cannot be sued by investors or depositors if they are negligent. The responsibilities devolving on auditors have enlarged over the years but the legal framework has not kept pace with the enlarged responsibilities. It is, therefore, necessary that the Code of Corporate Governance should cover external auditors as well and they should be made fully aware of the expectations of the owners of the banks beyond what are required in strictly legal terms. Apart from giving an opinion on "true and fair" view of the bank's financial position, auditors need to be made accountable to the depositors and employees of the bank through incorporation of necessary prescriptions for auditors in the Code.

A suggested Model Code of Best Practice for PSBs

- .. Bifurcation of the posts of the Chairman and Managing Director, to ensure a balance of power and authority.
- .. Boards should have a formal schedule of matters reserved for them for decision to ensure that the direction and control of the bank is firmly in their hands.
- .. Non-executive directors should be active, have defined responsibilities and be conversant with banks' accounts. Their caliber should be

such that their views carry significant weight in the board's decisions.

- .. Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, planning, key appointments and standards of conduct.
- .. There should be an agreed procedure for non-executive directors to take independent professional advice, if necessary.
- .. Re-appointment of non-executive directors should not be automatic, but should be based on an appraisal of their contribution to the board's functioning. Directors who have not been present for at least 50% of the board meetings should not be re-appointed. There should be a formal process for selection of non-executive directors.
- .. Chairman and Managing Director should have a minimum tenure of three years to ensure proper direction and continuity of policy.
- .. The Board should form an effective audit committee comprising at least three non-executive directors and this committee should be given access to all financial information. The chairman of the audit committee should be responsible for answering questions at the Annual General Meeting.
- .. The Report of the Board of Directors should contain information on monthly average share prices, performance of the bank's share vis-à-vis the accepted stock price indices, shareholding pattern, details of major defaults and bifurcation of provisions. Disclosure norms followed for a domestic public issue should be the same as those required for GDR issues.
- .. Institutional investors (like mutual funds, UTI, LIC, GIC and FIs) should encourage regular, systematic contact at senior executive level to exchange views

contd. on Page 19

Contd. from page 16

and information on strategy, performance, board membership and quality of management. They should ensure that a core of non-executive directors has the necessary calibre, experience and independence.

- .. The quality of shareholder communication should be improved. In addition to the annual reports, quarterly operational performance should also reach shareholders. If the number of shareholders is large, such statements be made publicly to ensure that they are equally available to all shareholders.
- .. All the directors should certify in the Directors' Report that the internal controls of the bank are adequate and the statutory auditors should certify that the bank is a going concern.
- .. A brief description of directors' responsibilities for the accounts should appear in the Directors' Report, as counterpart to a statement by the auditors about their reporting responsibilities. This would enable the shareholders to understand the boundaries between the duties of directors and auditors.

The adoption of such a code of self-discipline for good governance, it is true, will not be a panacea for all the ills afflicting the public sector banks. It will, however, be a major step in self-regulation through a concerted action by the board members, institutional investors and external auditors to improve the quality of governance of PSBs. In a deregulated milieu, the PSBs are bound to demand greater functional autonomy for flexibility in decision making. Such autonomy, however, needs to be accompanied by greater accountability on part of their boards to the stakeholders. A Code of Corporate Governance could be an effective instrument for achieving this goal ■