# Corporate Governance Practices in the Banking Sector

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## ABSTRACT

*Banking system plays a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. The Indian banking system is among the healthier performers in the world. In the liberalized economic environment and integration of the country, in to world market the corporate sector in India at present cannot ignore the importance of Corporate Governance. The Corporate Governance philosophy of banks has to be based on pursuit of sound business ethics and strong professionalism that aligns the interests of all stakeholders and the society. Strengthening of public confidence in banks is a vital requirement. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital efficiency are vital for success & continued survival of banks. The conclusion is that sound Corporate Governance would lead to effective & more meaningful supervision and could contribute to a collaborative working relationship between bank management & bank supervisors. Banks need to ensure good Corporate Governance in order to achieve excellence, transparency & for maximization shareholders value & wealth. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business, commitment to better customer service, adequate automation and proactive policies, banks will definitely be able to grapple with these challenges and convert them into opportunities.*

***Keywords:*** Corporate Governance, Banking

## INTRODUCTION

Banking system plays a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Indian banking industry, the backbone of the country economy, has always played a key role in prevention the economic catastrophe from reaching terrible volume in the country. The Indian banking system is among the healthier performers in the world. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital efficiency are vital for success & continued survival of banks. In the liberalized economic environment and integration of the country, in to world market the corporate sector in India at present cannot ignore the importance of Corporate Governance. Corporate Governance is now an issue and important factor that can be used as tool to maximize wealth of shareholders of a corporate. Corporate Governance aims are the Vision, Values and Visibility.

**Meaning of Corporate Governance**

In the $19^{th}$ century, state corporation law enhanced the rights of corporate boards to govern without unanimous consent of share holders in exchange for statutory Benefits like appraisal rights, in order to make corporate governance more efficient. It was in the late 1980's there was a growing awareness and a serious concern in the trade and business community in UK that all was not well with the system of corporate management. Deficiencies in the Accounting Standard became more evident, after many companies, in their eagerness to increase their earning and accelerate their growth, exploited the weaknesses in the accounting standards to inflate profits and understate liabilities, while companies grew phenomenon ally, accounting controls went lay wire.

In the first half of the 1990's the issues of corporate governance received considerable Press attention due to the wave of CEO dismissals their boards. Company's compliance with codes of ethics procedure for making decision on corporate affaires. It also provides the structure through which the company objectives are set well as the means of attaining and monitoring the performance of those objectives. "Corporate Governance in simple words is a set of system which ensures business movements and modules it in regulated & Leger format." Accountability of mangers, communication between management and investors transparency of corporation and disclosure.

**Importance of Corporate Governance in Banking**

Banks are a critical component of the economy while providing financing for commercial enterprises, basic financial services to a broad segment of the population and access to payment systems. The importance of banks to national economies is underscored by the fact that banking is, almost universally, a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have strong corporate governance practices.

Banks are also important catalysts for economic reforms, including corporate governance practices. Because of the systemic function of banks, the incorporation of corporate governance practices in the assessment of credit risks pertaining to lending process will encourage the corporate sector in turn to improve their internal corporate governance practices.

Importance of implementing modern corporate governance standards is conditioned by the global tendency to consolidation in the banking sector and a need in further capitalization.

**Best corporate governance practices will enable banks to:**

- Increase efficiency of their activities and minimize risks;
- Get an easier access to capital markets and decrease the cost of capital;
- Increase growth rate;
- Attract strategic investors;
- Improve the standards of lending;
- Protect the rights of minority shareholder and other counterparts;
- Strengthen their reputation and raise the level of investors and clients' trust.

## OBJECTIVES OF CORPORATE GOVERNANCE

Poor corporate governance may contribute to bank failures, which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macroeconomic implications such as contagion risk and impact on payment systems. In addition, poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could turn, trigger a bank run air liquidity crisis. Generally, banks occupy a delicate position in the economic equation of any country such that its performance invariably affects the economy of the country. Objectives of corporate governance are to establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization; Setting and enforcing clear lines of responsibility and accountability throughout the organization; Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns and Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment.

### Relation of Corporate Governance and Banking

Globalization of financial markets necessitates some basic international standards of corporate governance for financial institutions, it is also recognized that such uniform international standards may result in different levels of systemic risk for different jurisdictions because of differences in business customs and practices and institutional and legal structures of national markets. Each country will therefore need domestic regulations that prescribe specific rules and procedures for the governance of financial institutions that address national differences in political economic and legal systems while adopting international standards and principles.

Banks are “special” as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. The role of banks is integral to any economy. They provide financing for commercial enterprises access to payment systems and a variety of retail financial services for the economy at large. The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing in many cases a government safety net to compensate depositors when banks fail. The large number of stakeholders whose economic well being depends on the health of the banking system depend on implementation of appropriate regulatory practices and supervision. Indeed in a healthy banking system the regulators and supervisors themselves are stakeholders acting on behalf of society at large. As regulators we do not act on behalf of shareholders or individual customers but on behalf of groups such as depositors policyholders or pension fund members who rely on the continued solvency of regulated institutions for their financial security but who are themselves not well placed to assess financial soundness.

Banks unlike insurance companies are highly leveraged entities and asset liability mismatches are an inherent feature of their business. Consequently, they face a wide range of risks in their day-to-day operations. Any mismanagement of risks by these entities can have very serious and drastic consequences on a stand alone basis which might pose a serious threat for financial stability. This dimension further strengthens our premise that effective risk management systems are essential for financial institutions and emphasizes the need for these to be managed with great responsibility and maturity. Good corporate governance, therefore, is fundamental to achieve this objective.

**Role of Corporate Governance in Banking Sector**

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. In the case of traditional manufacturing corporations, the issue has been that of safeguarding and maximizing 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. 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. 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. 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. Some of the important recommendations on the constitution of the Board are to participate in the meetings of the board regularly and ensure that their participation is effective & contributory, They must study the reports submitted to them by the management team and enquire about follow up reports on definite time schedule. They should be actively involved in the matter of formulation of general policies, they should be familiar with the road objectives of the bank, and the policies laid down by the govt. and the changes in the various laws and legislations time to time. They should be loyal to the bank and must remember that they should not reveal any information relating to any constituent of the bank to anyone.

In the past, when banks considered the issue of how best to differentiate themselves from their competition, Good Corporate Governance was undoubtedly not applied. Due to the fallout from past corporate failures, more and more banks are looking at good corporate governance from a new perspective. With Indian economic growth increase and major stock Indices reaching record level, the time has come to position corporate governance as a strategic force in Indian banks. Indian banks must drive growth and profitability while continuing to focus on enhancing corporate governance practices. Indian government has mandating corporate governance reforms at banks, can create the necessary infrastructure to ensure the continued flow of investment into the region. Expanding global and regional banks, such as State Bank of India, Bank of Baroda, Bank of India, Punjab National Bank, ICICI Bank, HDFC Bank, Standard Chartered, HSBC, Citibank and others along with major investments by large institutional investor, are enhancing corporate governance practices, increasing competitiveness and permanently changing the competitive landscape of Indian banking environment. Due to rapidly changing banking environment, Indian banks must continue to implement strong corporate governance practices. They must now approach corporate governance as a competitive differentiator in an environment of strong foreign entrants and growing regional competitors.

**Need for Corporate Governances in Bank**

- Since banks are important players in the Indian financial system, special focus on the Corporate Governance in the banking sector becomes critical.
- The Reserve Bank of India, as a regulator, has the responsibility on the nature of Corporate Governance in the banking sector.
- To the extent that banks have systemic implications, Corporate Governance in the banks is of critical importance.
- Given the dominance of public ownership in the banking system in India, corporate practices in the banking sector would also set the standards for Corporate Governance in the private sector.
- With a view to reducing the possible fiscal burden of recapitalising the PSBs, attention towards Corporate Governance in the banking sector assumes added importance.

**Prerequisites for Good Governance**

There are some pre-requisites for good corporate governance. They are:

- A proper system consisting of clearly defined and adequate structure of roles, authority and responsibility.

- Vision, principles and norms which indicate development path, normative considerations and guidelines and norms for performance.
- A proper system for guiding, monitoring, reporting and control.

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**Evolution of Corporate Governance in Banking Sector**

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. 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. 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. In addition, 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. 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. 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: Transparency, Off-site surveillance and Prompt corrective action.

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 analyze 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. There are three major challenges facing governance ratings in India: Firstly there does not seem to be a clear objective in relation to the capital markets. The second challenge is that there is insufficient accumulated knowledge on corporate governance and a great amount of fluidity in the theory at present and the third challenge is to assign weightings to the companies in the context of global markets. The rating agencies need to reflect on these while the regulator refrains from putting pressure to initiate a rating system for corporate governance.

## CONCLUDING OBESRVATION

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. There is an assurance 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. In all the regards, the big banks will have the marked advantage over the small and medium sized banks. This might lead to considerable level of consolidation in the Indian Banking Industry. Indian banks are far behind their foreign counterparts in disclosing information to the public. Wake of increased competition from foreign banks, disclosure norms can serve to be important differentiating factor to attract and retain big corporate clients. 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, banks will definitely be able to grapple with these challenges and convert them into opportunities.

The real success of our financial sector reforms will however depend primarily on the organizational effectiveness of the banks, for which initiatives will have to come from the banks themselves. As the competition intensifies in the Indian banking market, banks can no longer look at corporate governance simply as a code of doing business but must utilize it as a tool lower risk and enhance shareholder value. Indian Banks can start by focusing on the five corporate governance themes, government can also learn how to effectively utilize and enforce corporate governance laws. There need to be an appropriate balance between regulatory and voluntary corporate governance requirements. Dr. Y. V. Reddy, the governor of RBI, has rightly said, "Corporate Governance is the only royal road to the portal of corporate success and there is no short cut to achieve the same. A short cut can lead to short circuiting, which can cause colossal loss to the banks concerned".

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