Corporate Governance In Banking Sector: A Legal Perspective

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Concept Of Corporate Governance

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of a company's stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community.

Corporate governance is of great consequence for markets all around the world. This is because financial and economic development revolves around good corporate governance practices. Corporate governance and economic development are inter-linked. Efficient corporate governance systems encourage the development of robust financial systems. Efficient corporate governance practices provide increasing returns to investors by lowering cost of capital by reducing risk. This creates superior firm valuation. Secondly, with effective corporate governance mechanisms in place, banks can ensure better allocation ofresources.[1]

Evolution And Significance Of Corporate Governance In The Banking Sector In India

In the banking sector the reforms of 1991 were seen as striking transformation. The private sector banks investing inthe industry and government shareholding in public sector banks went down. Liberalization also saw the entry of foreign banks on the Indian banking scene. The growth of the foreign banks and private sector banks entering the market bought with it growing competition. This outright forced all banks to improve their governance structure required for the increasing customer needs. Banks now had greater autonomy and responsibility. Improvement of corporate governance standards was the result derives from the entry of institutional and retail shareholders. Since then, many institutions have taken the initiative to contribute to the development of corporate governance.

The OECD formed its corporate governance principles in 1999. They were again revised in 2004. The Basel Committee on Banking Supervision published guidelines on corporate governance in banks in 1999.These norms are followed by banks all over. The most recent of these are known as the Basel III norms. A series of scandals in the United States led to reforms in corporate governance and disclosures in that country. In July 2002, the Sarbanes-Oxley Bill (also known as SOX) was enacted. The Act contained changes in several areas of corporate governance like financial disclosures and auditor responsibility.[2]

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[1] Available At : Http://Www.Investopedia.Com/Terms/C/Corporategovernance.Asp
[2] Brian Stafford, The Evolution of Corporate Governance, Available at http://diligent.com/wp-

In India, the first announcement in regard to corporate governance was made by Dr. BimalJalan, Governor of the Reserve Bank of India in 2001. An advisory group on corporate governance was formed under the chairmanship of Dr. R.H. Patil. It submitted its report in March 2001. The main purpose of the advisory group was to investigateinto matters relating to corporate governance in banks in India so as to make further recommendations to improve the governance standards in India with the best international standards.

A Consultative Group was then constituted in November 2001 under the Chairmanship of Dr. A.S. Ganguly. This group was formed to strengthen the internal supervisory role of the Boards. The report of the Ganguly Group was sent to all the banks and also the Government for consideration in June 2002.Subsequently, the advisory group on Banking Supervision under the chairmanship, Shri M.S. Verma also submitted its report in January 2003.

The role of the Reserve Bank then initiate to tighten the corporate governance in the Indian banking sector and take it up to a level with international standards. On 21 August 2002, the Department of Company Affairs (Ministry of Finance and Company Affairs) instituted a committee to look into various corporate governance issues in the country.

Various corporate governance initiatives were initiative in India since the mid 1990s. The first was the India's largest industry and business association, namely the Confederation of Indian Industry (CII), which introduce the first voluntary code of corporate governance in 1998. SEBI was the second which now depicts as Clause 49 of the listing agreement. Naresh Chandra Committee was the third to submit its report in 2002. The fourth was again given by SEBI the Narayana Murthy Committee, which also submitted its report in 2002. In August 2003 SEBI revised Clause 49 of the listing agreement based on the recommendations of this committee. Further, SEBI withdrew the Clause 49 in December 2003, and currently, the original Clause 49 is in force.

One of the important themes of corporate governance deals with the issues of accountability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behaviour and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare.[3]

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content/uploads/2015/12/The-Evolution-of-Corporate-Governance.pdf
[3]HemaliChokshi, Corporate Governance in Banking Sector- Indicating Transparency or

In India the concept of Corporate Governance is gaining importance because of two reasons:

FIIs and FIs became dominant players in the stock markets onset of institutionalization of financial markets after liberalization. The discrimination also beganbetween wealth destroyers in the market. Corporate Governance is aimportant crunch of market discipline.

Another factor is the increased role being played by the private sector.Companies are realizing that investors love to stay with those corporate thatcreate values for their investors. This is only possible by adopting fair, hone stand transparent corporate practices.

Banks are critical components of the economy while providing finance for commercial enterprises, basic financial services to a broad segment of the population and access to payment systems. Banks in India are facing increasing competition, within and outside India, both in terms of markets for its products and for sources of fund.

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. In order to meet the statutory need of having sound Capital Adequacy requirements, banks are accessing the Capital Market at regular intervals. Hence the banks need to stimulate the interest of investors at all times. Investors believe that a bank with good governance will provide them a safe place for investment and also give netter returns. Good corporate governance is therefore an important factor in a competitive environment. Investors, customers, employees and vendors have all become more discerning and are demanding greater transparency and fairness in all dealings. To attract and retain the commitment of investors, customers, employees, Banks should ensure that they match the global benchmark in 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. It is of crucial importance therefore that have strong corporate governance practices.

Translucency, Available at: http://journal.lawmantra.co.in/?p=136

Banks, just like any other organization are incorporated entities. As a result of which, the primary requirements of corporate governance apply to them as any other incorporated entity. Added to these certain features that are very specific to banks, adds on to the importance of Corporate Governance issues in banks.

Among other features, the most important one is the fact that banks form an integral part of the economy of the country, and any failure in a bank might have a direct bearing on the financialhealth of the country. Banks, help in channelizing the people's saving.[4]The capital structure of bank is unique in two ways. First, banks tend to have very little equityrelative to other firms. Second, banks' liabilities are largely in the form of deposits, which are available to creditors/depositors on demand, while their assets often take the form of loans thathave longer maturities. Thus, the principle attribute that makes banks as financial intermediaries "special" is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy. The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run.

The second important driver of a good corporate governance stems from their funding patterns. Banks, by their basic definition are highly leveraged financial institutions, with the equity capital of the shareholders being reduced to a miniscule proportion of loan capital in the form of borrowing and deposits of deposits from customers of the bank. As a result of this, the stakeholders in banks, (mainly the depositors and lenders) have a rightful claim of accountability from the banks and their boards.[5]

The third important element in the Corporate Governance structure relates to the control function.It is imperative to discuss the same in brief. Control functions in banks deal with internal frauds as well as external frauds. The former relates to situations where the banks own personnel indulge in corrupt and unethical practices. The latter deals with situations where the customers of the bank try to seek for malpractices. The incidents of the external

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[4]Available at https://blog.ipleaders.in/corporate-governance-in-the-banking-sector/

[5]Capiro G. Jr and Levine R., "Corporate Governance of Banks: Concepts and International Observations", paper presented in the Global Corporate Governance Forum Research Network Meeting

frauds are so devastating that special attention is being mandated both for their prevention as well as their post scenario analysis.

Finally, failing to comply with stipulated norms can be one of the challenging issues of Corporate Governance framework. With Banks being under intense watch of the central bank as well as other regulatory bodies, it is a common observation, that most failures (crashes) in banks have occurred due to compliance failure situations. With a lot of reports and norms, being introduced (The Basel II norms being the latest of them), failure to adhere to the regulatory norms have never reduced.

Corporate Governance And Basel Norms

The Basel Committee on Banking Supervision is a committee, of banking supervisory authorities, established by the Central Bank Governors of the G10 developed countries in 1975. The Committee in 1988 introduced the Concept of Capital Adequacy framework, known as Basel Capital Accord, with a minimum capital adequacy of 8 percent. It also issued a consultative document titled "The New Basel Capital Accord" in April 2003, to replace the 1988 Accord, which re-enforces the need for capital adequacy requirements under the current conventions. This accord is commonly known as Basel II and is currently under finalization. Basel II is based on three pillars:

Pillar 1 – Minimum Capital Requirements

Pillar 2 – Supervisory Review Process

Pillar 3 – Market Discipline

The Basel committee had issued, in August 1999, a guidance paper entitled "Enhancing Corporate Governance for Banking Organizations" to supervisory authorities worldwide to assist them in promoting the adoption of sound corporate governance practices by banks in their countries.[6]

Application Of Corporate Governance In The Banking Sector In India

The growing competitiveness and interdependence between banks and financial institutions in local and foreign markets have increased the importance of corporate governance and its

[6] Basel Committee on Banking Supervision (BCBS) Enhancing Corporate Governance for Banking Organisations. Switzerland: Bank for International Settlements

application in the banking sector. Corporate governance in banks can be achieved through a set legal, accounting, financial and economic rules and regulations. To make sure that the competence and integrity in banking sector is maintained, the need for uniform standards of the concept of governance in private and public sector is emphasized. The regulatory framework implemented by the central bank can affect the overall well being of banking sector.

Best Practices Of Banking System In Corporate Governance:

Good governance can be built based on the business practices adopted by the board of directors and management. Many bank failures in the past have been attributed to inadequate and insufficient management which enabled the banks to accept low quality assets and assume additional risks that extend beyond the level appropriate for the banks' capacity.

Important commandments for ensuring corporate governance in banks are:

Banks shall realize that the times are changing

Banks shall establish an Effective, Capable and Reliable Board of Directors

Banks shall establish a Corporate Code of Ethics for themselves

Banks shall consider establishing an office of the Chairman of the Board

Banks shall have an effective and Operating Audit Committee, Compensation Committee and Nominating/ Corporate Governance Committee

Banks shall consider Effective Board Compensation

Banks shall disclose the information

Banks shall recognize that duty is to establish Corporate Governance

Procedures that will serve to enhance shareholder value

The corporate governance mechanism as followed by Reserve Bank of India is based on three categories for governing the banks. They are

Disclosure and transparency: Disclosure and transparency are 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.

Off-site surveillance: 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.[7]

Recent steps taken by Banks in India for Corporate Governance are:

Introduction of non executive members on the Board

Constitution of various Committees like Management Committee, Audit Committee, Investor's Grievances Committee, ALM Committee etc.

Gradual implementation of prudential norms as prescribed by RBI

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[7]Nabanita De, Reserve Bank of India, the Gate- Keeper in Corporate Governance, available at http://www.academia.edu/13095477/Reserve_Bank_of_India_the_Gate-keeper_in_Corporate_Governance

Introduction of Citizens Charter in Banks

Implementation of "Know Your customer" (KYC) concept.[8]

Corporate Governance And Bank Credit Risk

Banks grant credits in the day-to-day transaction to customers with the expectation of repayment at the end of a specified time. However, sometimes such credits remain uncollectible; these uncollectible credits constitute what is known as non-performing loans (NPLs). Nonperforming loans are loans that are no longer producing income for the bank. Loans become nonperforming when borrowers stop making payments and the loans enter default. Non-performing loan according to the International Monetary Fund (IMF), is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 day's worth of interest has been refinanced, capitalized, or delayed by agreement, or payments are less than 90 days overdue, but are no longer anticipated; that is, there are good reasons to doubt that payments will be made in full.

The risks associated with non-performing loans are very serious in banking business.[9]

Thus, in order to manage risk, banks need to take effective governance measures. These are:

Fundamental Risk Management Policies: With the deregulation and internationalization of the financial sector and the diversification of financial services and businesses, the risks to which banks are exposed are becoming more complex and diverse, heightening the importance of risk management. Thus, a fundamental risk management policy is vital to gain an accurate understanding and awareness of each type of risk, and to establish an appropriate risk management framework to maintain the soundness and adequacy of management and secure stable income.

Comprehensive Risk Management System:Banks need to have a comprehensive system to understand and manage the risks they face in conducting its banking operations.

Specifically, risks such as credit risk, market risk and operational risk are categorized, and a unit is designated as having principal responsibility for managing each type of risk in the

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[8]Kohli S.S., "Corporate Governance in Banks: Towards Best Practices", IBA Bulletin, pp.29-31, 2003

[9] Subramanian, Ulaganathan, Corporate Governance, Credit Risk, Performance and its Determinants of Banks in BRICS Countries & Applications for Banks in Brunei Darussalam (February 15, 2015). Available at SSRN: https://ssrn.com/abstract=2565324

course of operations. In addition, Banks shall establish the Risk Management Division, which shall be responsible for overall management of these risks. Moreover, by conducting internal audits through auditing units that are independent from business divisions, the Banks shall examine the appropriateness and effectiveness of management within each of its divisions.

Credit Risk Management: One of the most important management tasks for a bank is maintaining the soundness of loans and other assets .Banks therefore need to effectively implement a credit rating system that employs consistent criteria to evaluate the credit risk of each borrower and loan, and formulates lending policies and sets interest rates taking creditworthiness into account. In addition, the Banks need to establish a credit policy that controls the concentration of credit in any specific company or corporate group, and strives to diversify risk associated with loans by understanding their distribution by industry, region, credit rating, credit amount and other categories from the standpoint of credit portfolio management.[10]

Impact of Corporate Governance Policies in Banks

The RBI move to strengthen Corporate Governance led to seminal changes in the administration of banks.The sustained profitability, lower level of non-performing assets, improved return on assets etc are some of the laud indicators of the sustaining policy of operating sound banking system. Moreover, the movement of share prices in the market, increased appetite of investors to look at banks for investment in bank centric equity market further speaks of broad market opinion of bank's performance and reflection of market confidence. The corporate governance framework in banks has been strengthened through regulation, supervision and by maintaining constant interaction with the management. They cover identification of responsibilities of the Boards of banks, disclosure and transparency in published accounts, and shareholder and stakeholder rights and controls. The rating on management (M) which has been introduced as part of the CAMELS (Capita, Asset Quality, Management, Earnings, Liabilities and Systems) supervisory process takes into account the working of the board and its committees including the Audit committee, effectiveness of the management in ensuring regulatory compliance and adequacy of control exercised by the head/controlling offices. This model has been further modified to include risk based

[10] Available at:https://researchersclub.wordpress.com/2013/10/24/corporate-governance-a-much-factor-in-the-present-world-economic-scenario/

supervision. The new evolution is intended to manage influx of a range of financial risks entering the market with their nuances.

Moreover, the audit function is an important element of the corporate governance process and the independence of this function is crucial to good corporate governance. Audit Committee of the Boards, constituted at the instance of RBI; performs the role of overseeing concerns about internal controls and recommendations for their improvement. In order to ensure both professionalism and independence of these committees, Chartered Accountant directors on the boards of banks are mandatory members and the Chairman or Chief Executive Officer is not to be part of the Audit Committee. Foreign banks are not insisted upon to have local audit committee for their Indian branches. Their branches can have a compliance function that reports to their head office on the branches' compliance with RBI inspection findings and features arising out of internal inspections and statutory audit. RBI has Nominee directors on the boards of all PSBs and some of the old private sector banks. Further, the Government also nominates directors on the boards of all PSBs. Of late, RBI has been withdrawing its nominees from the boards of well-managed old private banks.

In order to improve the effectiveness of the non-official directors and bring in effective corporate governance at the board level in banks, guidelines have been issued focusing the attention of directors on certain areas such as (i) theprescribed calendar of reports / returns to be placed before the Board / Managing Committee of the bank (iv) corrective action required to be taken by the bank on issues of supervisory concern (v) adherence to the deadlines for complying with various action points committed under Monitor able Action Plan during discussions in Annual Financial Inspection findings as well as achievement of targets agreed during Memorandum of Understanding (MOU) discussions with RBI. Further, the guidelines also require the directors to keep watch on matters which come to the board of the banks as also what should have come to the board and to inform the Department of Banking Supervision on matters of supervisory concern.[11]

Also, the Post reform period led to many banks accessing capital market to shore up their capital adequacy ratio, an essential prescription of Basel-I then and Basel–II now. Subscription of bank's equity is a function of public confidence which stems from governance policies. The Red Herring Prospectus lodged by banks are required by the capital

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[11] Subramanian, Ulaganathan, Corporate Governance, Credit Risk, Performance and its Determinants of Banks in BRICS Countries & Applications for Banks in Brunei Darussalam (February 15, 2015). Available at SSRN: https://ssrn.com/abstract=2565324

market regulator, the Securities and Exchange Board of India (SEBI) reflects not only the numerical performance of banks as enunciated in Section-I of this paper but is also an indicator of present and future governance policies pursued by banks.

The movement of stock prices is a further reflection of demand and supply of bank shares in the stock market. The entry of new Private Sector Banks and PSBs accessing capital market opened up new opportunities to the investors. It was heartening to note that in the next few years, the bank shares had picked up demand and popularity.

The spurt in the capital market index is a manifestation of investor opinion on theperformance, potential and standard of governance of banks. Though there may not be direct correlation between market movement of bank shares and corporate governance policies, the overall long run market opinion precipitates on this basis. Such practices form the fundamental strength of the banks and their ethical commitments. As the risk perception changes, volume of business goes up, new line of activities spur, competition heightens further, the Corporate governance practices need to be fine tuned to meet the emerging challenges.

Weaknesses of Corporate Governance in India

No Proper Structure: It is true that the ‘corporate governance’ has no unique structure or design and is largely considered ambiguous. There is still lack of awareness about its various issues, like, quality and frequency of financial and managerial disclosure, compliance with the code of best practice, roles and responsibilities of Board of Directories, shareholders rights, etc. There have been many instances of failure and scams in the corporate sector, like collusion between companies and their accounting firms, presence of weak or ineffective internal audits, lack of required skills by managers, lack of proper disclosures, non-compliance with standards, etc. As a result, both management and auditors have come under greater scrutiny.

But, with the integration of Indian economy with global markets, industrialists and corporate in the country are being increasingly asked to adopt better and transparent corporate practices. The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for taking key investment decisions. If companies are to reap the full benefits of the global capital market, capture efficiency gains, benefit by economies of scale and attract long term capital, adoption of corporate governance

standards must be credible, consistent, coherent and inspiring. Individual shareholders, who usually do not exercise governance rights, are highly concerned about getting fair treatment from controlling shareholders and management. Creditors, especially banks, play a key role in governance systems, and serve as external monitors over corporate performance. Employees and other stakeholders also play an important role in contributing to the long term success and performance of the corporation. Thus, it is necessary to apply governance practices in a right manner for better growth of a company.

Insider Trading

Corporate insiders like officers, directors and employees by the virtue of their position have access to confidential information about the corporation and may misappropriate that information to reap profits. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take advantage of non-public information. However, the term is frequently used to refer to a practice in which an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation, or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company. Such corporate insiders use these information in such a way to reap profits or avoid losses on the stock market, to the detriment of the source of the information and to the typical investors who buy or sell their stock without the advantage of "inside" information.[12] The term insider trading is popularly used in the negative sense as it is perceived that the persons having access to the price sensitive and unpublished information used the same for their personal gains. However insider trading per se does not mean any illegal conduct. It encompasses both legal as well as illegal conduct. The legal version is when corporate insider's officers, directors, and employees buy and sell stock in their own companies. In order to legalize their transactions, the directors and employees of the company should inform about their dealing with the securities to the SEBI. Insider trading is defined as-"The use of material non public information in trading the shares of the company by a corporate insider or any other person who owes a fiduciary duty to the company".[13]SEBI is the watchdog of all the stock exchanges in India. It has been obligated to protect the interest of the investors in the securities market and to regulate the stock market through such other regulations as it deems

[12]Available at: http://works.bepress.com/pankaj_singh/2/
[13]Black's Law Dictionary

fit. It is due to the very fact that the investors invest on the shares being speculative, but when the prices of the shares could be predicted well before in hand then they may take a decision accordingly. Hence, pre determined price may result in undesired consequences as people may buy huge amount of shares whose value may appreciate.

In the case of Samir.C.Arora vs. SEBI[14] Mr. Arora was prohibited by the SEBI in its order not to buy, sell or deal in securities, in any manner, directly or indirectly, for a period of five years. Also, if Mr. Arora desired to sell the securities held by him, he required a prior permission of SEBI. Mr. Aroracontested this order of SEBI in the Securities Appellate Tribunal. SAT set aside the order of SEBI on grounds of insufficient evidence to prove the charges of insider trading and professional misconduct against Mr. Arora.

This case testifies the fact that the SEBI lacks the thorough investigative mechanism and a vigilant approach due to which the culprits are able to escape from the clutches of law. In most of the cases, SEBI failed to adduce evidence and corroborate its stance before the court. Unlike the balance of probabilities that is required in proving a civil liability, a case involving criminal liability requires the allegations to be proved beyond reasonable doubts. Therefore there should be thread bare investigation and all the loopholes if any should be properly plugged in.

Conclusion

Banks form a crucial link in a country's financial system and their wellbeing is imperative for the economy. The significant transformation of the banking industry in India is clearly evident from the metamorphism of the financial markets. Globalization has bought with it greater competition and consequently greater risks. In such scenario, implementation of good corporate governance practices in banks can ensure them to cope with the changing environment and ensure greater transparency in operations.

[14](2002) 38 SCL 422.