Duvvuri Subbarao: Corporate governance of banks in India in pursuit of productivity excellence

Inaugural address by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the FICCI-IBA (Federation of Indian Chambers of Commerce & Industry – Indian Banks' Association) Conference on "Global Banking: Paradigm Shift", Mumbai, 23 August 2011.

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For the third year in a row, it is my privilege to be addressing this joint conference of FICCI and IBA. I know both corporates and banks attach a lot of value to this conference, and so does the Reserve Bank. A joint forum of FICCI and IBA is an important platform for us in the Reserve Bank to share our views on topics of current relevance with two important segments of the economy – corporates and banks – which have a vital role in, and responsibility for, driving growth and development.

Indian banking – productivity excellence

The theme of this conference – *Indian Banking – Productivity Excellence* – has perennial relevance, but is much more relevant now, as going forward incremental growth will depend increasingly on productivity growth. India witnessed a remarkable growth acceleration in the years before the crisis; many of the factors that aided this have been acknowledged. But, as I have said before, one of the unacknowledged drivers of that growth performance has been the improvement in the quantum and quality of financial intermediation led by the commercial banking sector. We need to build on that achievement, and productivity improvement is by far the most vital instrument for doing so.

Over the next two days, you will be contemplating the challenges of productivity improvement in banking. How can I add value to that? I could cover a breadth of issues that warrant attention, but that is clearly not the Reserve Bank's comparative advantage. Instead, I have decided to focus on a single topic: *Corporate Governance of Banks in India*. This choice has been motivated by more than one factor. This conference is jointly organized by FICCI which pursues the interests of corporates, and IBA which looks after the interests of banks. I have simply inserted the Reserve Bank's area of interest, "governance", between corporates and banks so that all our collective interests are covered. And importantly, I believe more effective and enlightened corporate governance of Indian banks can be a vital avenue for improving banking productivity.

Why is corporate governance important?

Before going into corporate governance of banks in particular, let us recall, just for the sake of context, why corporate governance is important in general. At its most basic level, corporate governance sets up the "rules of the game" to deal with issues arising from separation of ownership and management so that the interests of all stakeholders are protected. Empirical evidence shows that businesses with superior governance practices generate bigger profits, higher returns on equity and larger dividend yields. Importantly, good corporate governance also shows up in such soft areas as employee motivation, work culture, corporate value system and corporate image. Conversely, the failure of high profile companies such as BCCI, Enron, WorldCom and Parmalat was a clear lesson of the damage bad corporate governance can inflict.

Here at home we had a corporate scandal of unprecedented dimensions in Satyam Computers where the company's CEO admitted to having falsified accounts to the tune of over 7000 crore, and that too spread over several years. Even as the judicial process relating to this alleged fraud is still under way, the big question is in what ways was this a failure of corporate governance and how are we fixing those lacunae? We had instances of poor governance in the banking sector as well – erosion of standards in forex derivative transactions and fraud in wealth management schemes – reminding us that we need to work hard to get to best practice in every area of corporate governance.

How is corporate governance of banks different?

Banks are different from other corporates in important respects, and that makes corporate governance of banks not only different but also more critical. Banks lubricate the wheels of the real economy, are the conduits of monetary policy transmission and constitute the economy's payment and settlement system. By the very nature of their business, banks are highly leveraged. They accept large amounts of uncollateralized public funds as deposits in a fiduciary capacity and further leverage those funds through credit creation. The presence of a large and dispersed base of depositors in the stakeholders group sets banks apart from other corporates.

Banks are interconnected in diverse, complex and oftentimes opaque ways underscoring their "contagion" potential. If a corporate fails, the fallout can be restricted to the stakeholders. If a bank fails, the impact can spread rapidly through to other banks with potentially serious consequences for the entire financial system and the macroeconomy.

All economic agents tend to behave in a procyclical manner, and banks are no exception, as aptly summed up by Chuck Prince, the former CEO of Citigroup, who said that one had to keep dancing as long as the music was on! Where banks differ is that their procyclical behaviour hurts not just the institution but the larger economy. Among the many lessons of the crisis is the one that financial markets are not self-correcting. This is in part because the signals of financial instability are difficult to detect in real time. On top of that, banks escape some of the disciplinary pressures of the market as their balance sheets are typically opaque.

Given the centrality of banks to modern financial systems and the macroeconomy, the larger ones become systemically important. That raises a moral hazard issue since systemically important banks will then indulge in excessive risk in the full knowledge that all the gains will be theirs; and should the risks blow up, the government or the central bank will bail them out and thereby the losses can be socialized. Having collectively experienced the biggest financial crisis of our generation over the last three years, we all know that these risks and vulnerabilities of the financial system are not just text book concepts; they are all highly probable real world eventualities.

If banks are "special" in so many ways that I have indicated above, it follows that corporate governance of banks has to be special too, reflecting these special features. In particular, boards and senior managements of banks have to be sensitive to the interests of the depositors, be aware of the potentially destructive consequences of excessive risk taking, be alert to warning signals and be wise enough to contain irrational exuberance. Post-crisis, there is a debate on the extent to which failure of corporate governance has been responsible for the crisis. Given such overwhelming evidence of corporate governance failure, this is a futile debate. The short point is this. If the directors on the boards of banks didn't know what was going on, they should ask themselves if they were fit enough to be directors. If they did know and didn't stop it, they were complicit in the recklessness and fraud.

In fact, the post-crisis verdict on corporate governance of banks is quite damning. The Institute of International Finance, an association of major international banks, has concluded after an examination of board performance of banks in 2008 that, "events have raised questions about the ability of certain boards to properly oversee senior managements and to understand and monitor the business itself". As per an OECD report, nearly all of the 11 major banks reviewed by the Senior Supervisors Group (an informal group of senior supervisors under the auspice of the Financial Stability Board – FSB) in 2008 failed to anticipate fully the severity and nature of the market stress. On the positive side, there is some early evidence that banks with stronger corporate governance mechanisms moderated the adverse impact of the crisis on them, had higher profitability in 2008 and provided substantially higher stock returns in the immediate aftermath of the market turmoil.

A relevant question in this context is whether there are any additional dimensions to corporate governance of banks in emerging economies. Indeed there are, and I will cite just two important ones. First, in emerging economies, banks are more than mere agents of financial intermediation; they carry the additional responsibility of leading financial sector development and of driving the government's social agenda. Second, in emerging economies, the institutional structures that define the boundaries between the regulators and the regulated and across regulators are still evolving. Managing the tensions that arise out of these factors makes corporate governance of banks in emerging economies even more challenging.

Regulation and corporate governance of banks

Regulation has historically had a significant role in the evolution of corporate governance principles in the banking industry. However, to believe on this basis that good regulation can offset bad corporate governance will be patently wrong. Regulation can complement corporate governance, but cannot substitute for it.

The crisis has triggered a swathe of financial reforms to mitigate some of the known risks revealed by it. Understandably, these reforms also encompass corporate governance. Several countries have effected major structural changes to improve the functioning of their financial institutions, to ensure the robustness of their risk management systems and to make their operations more transparent. By far the most notable has been the Dodd-Frank Act in the United States which, among other things, aims to induce greater transparency with regard to the board and the top management positions and their compensation.

While regulation has a role to play in ensuring robust corporate standards in banks, the point to recognize is that effective regulation is a necessary, but not a sufficient condition for good corporate governance. Regulation can establish principles and lay down rules but the motivation to implement these principles and rules in their true spirit is a matter of organizational culture. If banks see adherence to regulation as a mere compliance function, and not as a culture building objective, the ability of regulation to further corporate governance can be quite restrictive. Let us take the example of bank audits. The effectiveness of external auditors is a critical component of a sound corporate governance framework. As long as audit is being done, the regulatory requirement is complied with. But is the audit effective? Has the audit unearthed all the frauds, excesses and mistakes? Has the audit led to sustainable and systemic corrective action? If the answer is "no", then the corporate governance of banks is faulty or ineffective.

Evolution of corporate governance of banks in India

Let me now briefly sketch the evolution of corporate governance of banks in India. In the pre-reform era, there were very few regulatory guidelines covering corporate governance of banks. This was reflective of the dominance of public sector banks and relatively few private banks. That scenario changed after the reforms in 1991 when public sector banks saw a dilution of government shareholding and a larger number of private sector banks came on the scene. How did these changes shape the post-reform standards of corporate governance?

First, the competition brought in by the entry of new private sector banks and their growing market share forced banks across board to pay greater attention to customer service. As customers were now able to vote with their feet, the quality of customer service became an important variable in protecting, and then increasing, market share.

Second, post-reform, banking regulation shifted from being prescriptive to being prudential. This implied a shift in balance away from regulation and towards corporate governance. Banks now had greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. The boards of banks had to assume the primary responsibility for overseeing this. This required directors to be more knowledgeable and aware and also exercise informed judgement on the various strategy and policy choices.

Third, two reform measures pertaining to public sector banks – entry of institutional and retail shareholders and listing on stock exchanges – brought about marked changes in their corporate governance standards. Directors representing private shareholders brought new perspectives to board deliberations, and the interests of private shareholders began to have an impact on strategic decisions. On top of this, the listing requirements of SEBI enhanced the standards of disclosure and transparency.

Fourth, to enable them to face the growing competition, public sector banks were accorded larger autonomy. They could now decide on virtually the entire gamut of human resources issues, and subject to prevailing regulation, were free to undertake acquisition of businesses, close or merge unviable branches, open overseas offices, set up subsidiaries, take up new lines of business or exit existing ones, all without any need for prior approval from the Government. All this meant that greater autonomy to the boards of public sector banks came with bigger responsibility.

Lastly, a series of structural reforms raised the profile and importance of corporate governance in banks. The “structural” reform measures included mandating a higher proportion of independent directors on the boards; inducting board members with diverse sets of skills and expertise; and setting up of board committees for key functions like risk management, compensation, investor grievances redressal and nomination of directors. Structural reforms were furthered by the implementation of the the Ganguly Committee recommendations relating to the role and responsibilities of the boards of directors, training facilities for directors, and most importantly, application of “fit and proper” norms for directors.

Some important issues relating to corporate governance of banks in India

Let me move on to discussing a few issues in corporate governance of banks which should engage our collective attention. I will do so under five headings.

Bank ownership

The first issue concerns ownership. There is typically a divergence between the interests of shareholders and of depositors. Shareholders want profits to be maximized by taking on greater risk; depositors have an overriding preference for the safety of their deposits and hence for lower risk. At the same time, depositors have little say in the governance of banks whereas the shareholders’ say is very pronounced. Within the shareholder group, the extent of control exercised by promoter shareholders too is an important determinant of the effectiveness of corporate governance. As some recent instances demonstrated, such excessive influence of promoters can turn the board into a mouthpiece of the promoter to the detriment of the interests of all other stakeholders.

Another way to look at the issue of ownership is in terms of public vs. private ownership. If banks are publicly owned, issues of conflict of interest between shareholders and depositors get mitigated. Public ownership of banks would also inspire confidence in the financial system. On the other hand, an important question is whether effective and autonomous corporate governance is compatible with public ownership of banks. The question arises because publicly owned banks render accountability to the government and to the democratic institutions. The government judges them on criteria quite different from those used by the market. How can we resolve this dilemma? Is it possible to stay with public ownership but still give near total autonomy to the boards? Is it, in particular, possible to cede the power to appoint the CEO to the board, but make the board accountable to the government and the shareholders for the performance of the bank?

Diversified ownership and "fit and proper" status of shareholders are other important determinants of corporate governance. The Reserve Bank's guidelines on ownership and governance in private sector banks, issued in February 2005, were aimed at ensuring that ownership and control of banks are well diversified. The Reserve Bank has been consistently following up with banks having concentrated ownership to ensure adherence to the prescribed limits in a time bound manner. Similarly, to ensure "fit and proper" status of large shareholders, acknowledgement from Reserve Bank is mandatory for any acquisition of shares in private sector banks resulting in a shareholding of 5 per cent or more of the total paid up capital of the bank. Having said that, it must be acknowledged that evaluating "fit and proper" is far from being a science; it involves a considerable amount of judgement. Moreover, "fit and proper" is a one time exercise, not repeated unless new information comes in. These limitations need to be recognized.

Another issue in ownership of banks, one that we highlighted in our Discussion Paper on new bank licences, is whether corporates should be made eligible to promote banks. International experience in this regard is varied. There are persuasive arguments both for and against the proposal. The strongest point in favour is that corporates can bring in the capital as also business experience and managerial competence. By far the biggest apprehension is about self-dealing – that corporates will use the bank as a private pool of readily available funds.

There are, of course, both statutory and regulatory checks against self-dealing. For example, the Banking Regulation Act expressly prohibits banks from lending to directors on the board and to entities in which they are interested. Regulations also prohibit lending to relatives of directors without the prior approval or knowledge of the board. Directors, who are directly or indirectly interested in any loan proposal, are required to disclose such interest and to refrain from participating in the discussion on the proposal.

As much as these prescriptions are extensive, there are still gaps. For instance, if a corporate has an interest in a bank as a promoter or a shareholder, but has no position on the board, then there is no prohibition on the bank lending to the corporate. This opens up opportunities for self-dealing. Another apprehension that was raised during the public debate on the Discussion Paper was that it is not easy for supervisors to prevent or detect self-dealing because banks can hide related party lending behind complex company structures or through lending to suppliers of the promoters and their group companies. As we contemplate allowing corporates to promote banks, there is need for changes in statutes and regulations to address these concerns.

Accountability, transparency and ethics

The separation of ownership and management can create conflict of interest if there is a breach of trust by managers on account of intention, omission, negligence or incompetence. This can be taken care of by making boards more accountable to all stakeholders and making their functioning transparent. Over the years, we have tried to align our transparency and disclosure standards to global best practices. But we need to ask questions. Is the voice of independent directors always independent? Do bank CEOs countenance criticism from the board? Are boards succumbing to "group think" and abandoning their responsibility for independent judgement? It is only through such soul searching that corporate governance of banks can improve its effectiveness.

The failure on the scale we saw during the recent global financial crisis is also reflective of poor ethical standards in banks. Almost all the complex gamut of causes of the crisis relate to how the financial system operated. The behaviour of actors across the chain of the financial sector was swayed by the opportunity for making quick profit rather than by fair, ethical and moral standards. Neither were the sub-prime borrowers adequately warned that there was a good chance of fall in asset prices nor did investment advisers tell their clients of the risk they were taking in buying MBAs and CDOs. Such behaviour was not only not checked, but was even encouraged.

Here at home, though our banking sector largely escaped the crisis, we should introspect on our own shortcomings and loose practices. To what extent have banks deviated from proper conduct in the sale of forex derivatives? Is there too much focus on the quarterly earnings cycle to the detriment of longer term performance? Are aggressive strategies leading to excessive risk taking? Issues such as these, I believe, underscore the special ethical dimension of the financial sector over and above that of other businesses. Boards of banks and financial institutions have to be conscious of their obligation not to hold the larger public interest hostage to their private profit motive.

Compensation

Compensation in the banking sector has been another high profile issue post-crisis. It is now widely acknowledged that the flawed incentives framework underlying banks' compensation structures in the advanced countries fuelled the crisis. The performance-based compensation of bank executives is typically justified on the ground that banks need to acquire and retain talent. We now know, with the benefit of hindsight, that this argument overlooked the perverse incentives it would engender. Bank executives were motivated by short-term profits even if it compromised long term interests. The Financial Stability Board (FSB) has since evolved a set of principles to govern compensation practices, and the Basel Committee has developed a methodology for assessing compliance with these principles. The proposed framework involves increasing the proportion of variable pay, aligning it with long-term value creation and instituting deferral and claw-back clauses to offset future losses caused by the executive.

In contrast to most other jurisdictions, the Reserve Bank has the power, in terms of the Banking Regulation Act, to regulate board compensation, including the pay and perquisites of the CEO of private sector banks. In evaluating compensation proposals for wholetime directors and CEOs of private sector banks, the Reserve Bank is guided by relevant factors such as the performance of the bank, compensation structures in the peer group, industry practice and regulatory concerns, if any. As regards bonus, in terms of the Reserve Bank guidelines issued in August 2003, bonus in respect of wholetime directors and CEOs has been capped at 25 per cent of their salary or at the level of bonus paid to other employees of the bank.

Post crisis, reflecting the spirit of the global initiative on compensation structures, we determined that there is a need for reform in India too. Accordingly, in July 2010, the Reserve Bank issued draft guidelines on "Compensation of Whole Time Directors/Chief Executive Officers/Risk Takers and Control Staff", inviting public comments. The draft guidelines proposed that banks should have a compensation policy, align compensation structures with prudent risk taking and institute a claw back mechanism. These guidelines were originally intended to be implemented with effect from 2011–12 but that schedule was deferred as the Basel Committee was in the process of finalising methodologies for alignment between risk, performance and remuneration. Meanwhile, the Reserve Bank carried out impact studies on select banks. Taking into account the feedback received on the draft guidelines, the result of the impact studies and the final prescriptions issued in the matter by the Basel Committee in May 2011, the Reserve Bank is in the process of finalizing the guidelines relating to compensation. The guidelines are scheduled to be implemented from the financial year 2012–13, and banks have already been advised to start preparatory work in this regard.

Another relevant aspect is the compensation of non-executive directors on the board. There is a view, also articulated in the Government of India's Corporate Governance Voluntary Guidelines 2009, that companies should have the option of giving a fixed contractual remuneration, not linked to profits, to non-executive directors. In the banking sector, non-executive directors are typically compensated through sitting fees, except non-executive chairmen who are paid a regular remuneration.

The question is whether non-executive directors of banks should also be paid a regular or a fixed contractual remuneration. This is probably a good concept, but difficult to implement in practice. Typically, in banks, the outcomes of risks taken become manifest after a long gap. While it is possible to align compensation of executives to the risks since they are long term employees, it is more problematic in the case of non-executive directors who serve for relatively shorter periods and have term limits. Furthermore, unlike wholetime executive directors, non-executive directors function collectively as a part of the board and committees of boards making it difficult to apportion responsibility on them individually. Notwithstanding these implementation issues, we need to debate on how to align the compensation of non-executive directors to the outcomes of corporate governance.

Splitting the posts of chairman and CEO of banks

Splitting the posts of the Chairman and the CEO of banks is another issue that has generated a contentious debate. The Ganguly Committee appointed by the Reserve Bank had recommended that the posts of the chairman of the board and the CEO of the bank should be bifurcated. The logic is that such a bifurcation of leadership of the board from the day to day running of the business will bring about more focus and vision as also the necessary thrust to the functioning of the top management of the bank. It will also provide effective checks and balances.

The Reserve Bank implemented the Ganguly Committee recommendations in all the private sector banks in 2007. Experience shows that this arrangement has worked well. In fact, the Ganguly Committee recommendation to this effect has been echoed by the Basel Committee on Banking Supervision (BCBS) in its document entitled, "Principles for Enhancing Corporate Governance" which was put out last year. Let me quote briefly from the document. It says, "to achieve appropriate checks and balances, an increasing number of banks require the chair of the board to be a non-executive, except where otherwise required by law. Where a bank does not have this separation and particularly where the roles of the chair of the board and Chief Executive Officer (CEO) are vested in the same person, it is important for the bank to have measures in place to minimize the impact on the bank's checks and balances of such a situation (such as, for example, by having a lead board member, senior independent board member or a similar position)."

Given our own positive experience as well as the global endorsement for this position, the question is whether we should extend the principle of separation of the posts of chairman of the board and CEO to public sector banks as well. An important criterion for deciding on this will be to what extent we will be able to lay down and enforce strict eligibility criteria for the position of the chairman of the board of a public sector bank. We will discuss this issue with the Government. Meanwhile, it will be useful if there is some debate on this issue.

Corporate governance under financial holding company structure

As we all know, the prevalent model for financial conglomerates in India has been the bank subsidiary model as opposed to the more popular financial holding company (FHC) model around the world.

The risks of a bank subsidiary model are quite well known. First, the burden of corporate management of the bank as well as of equity infusion in the future will fall on the bank, and that may stretch its managerial competence and financial capacity. Second, a concern from the regulatory perspective is that the losses of subsidiaries will impact the balance sheet of the bank and even jeopardize the interests of the depositors of banks. Third, a bank typically has access to implicit subsidy by way of safety-net, deposit insurance, access to central bank liquidity and access to payment systems. The bank subsidiary model opens up an avenue for leakage of the subsidies to the non-bank subsidiaries raising a moral hazard issue. Finally, there will also be the problem of resolution if the bank, or any of its subsidiaries, gets into trouble.

It is interesting that in the recent global financial crisis, financial conglomerates suffered equally irrespective of under which model they were structured. While the post-crisis reforms do not specify a preference for either model, the focus with respect to structure is on strengthening capital requirements at the consolidated level, reducing complexities of structures to enable efficient resolution in case of a problem, and separation of investment banking from commercial banking.

The Shyamala Gopinath Working Group appointed by the Reserve Bank has recommended that the financial holding company model should be pursued as a preferred model for the financial sector in India. We must recognize that regardless of the corporate structure, banks cannot be totally insulated from the risks of non-banking activities of their affiliates. In moving to a new regime, we must also contend with legacy issues relating to existing conglomerates. Any framework to harmonise them under the FHC model will require a new legislation and new regulatory architecture.

Conclusion

Let me now conclude. It has been my endeavour to emphasize how good corporate governance should be an important element in the pursuit of productivity excellence. I have highlighted how banks are different from other corporates and how this casts larger and more complex responsibilities on their corporate governance. I have briefly traced the changes in the Indian banking structure following the reforms in 1991 and how this has had important implications for corporate governance. Finally, I highlighted important issues in five areas covering corporate governance of banks which should engage our collective attention.

A final thought as I finish. Should corporate governance in general, and corporate governance of banks in particular, be motivated only by measurable performance indicators or is there something more to it? In his erudite and insightful book, *The Difficulty of Being Good*, Gurcharan Das turns to our great epic, *The Mahabharata*, to explore the elusive notion of *dharma*.

This discourse, I believe, is very contextual as *dharma* was wounded by the failure of corporate governance in the financial sector in the period leading up to the crisis. *Dharma* is exemplified when Draupadi exhorts her husband, Yudhishthira who gambled away his kingdom, to raise an army and fight back. "What is the point of being good?" she argues. "Isn't it better to be powerful and rich than to be good in an unfair world, where those who cheat sleep on sheets of silk while those who are good are condemned to the hard ground? Why be good?" To this Yudhishthira replies in the only way he knows: "I act because I must". The king's answer represents the uncompromising, compelling voice of *dharma*. Leadership everywhere is about inspiring people. You can inspire in many ways – through energy, enthusiasm, earnestness, intelligence and determination. But the most lasting inspiration is through *dharma*. When Yudhishthira tells Draupadi that he acts because he must, he is demonstrating character in its quintessence.

I hope this ideal of *dharma* that is so much a part of Indian heritage and culture will guide and inform corporate governance of our banks.