Y V Reddy: Public sector banks and the governance challenge - the Indian experience

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The objective of this paper is to detail the Indian experience in meeting the governance challenge with special reference to public sector banks (PSBs) or State-owned banks as they are described in some countries. The paper sets out the historical context of the Indian experience since the governance challenge is significantly related to the background in which state ownership emerged. This will be followed by an account of the pre-reform status encompassing the policy, regulatory and structural environments. The measures undertaken to tackle the governance issues during the reform follow. In the context of the recent on-going exercise relating to India's status, *vis-à-vis* the international standards and codes, an assessment would be made on the governance issues with special reference to the banking sector, based essentially on the assessment of independent advisory groups and current proposals under consideration for enhancing corporate governance in the public sector banks are discussed. An attempt would be made to highlight what may be termed as tentative issues and lessons emerging from the Indian experience. By way of a summing up, some random thoughts are set out to provoke analysis and debate on the subject.

Historical context

India had a fairly well developed commercial banking system in existence at the time of independence in 1947. The Reserve Bank of India (RBI) was established in 1935. While the RBI became a state owned institution from January 1, 1949, the Banking Regulation Act was enacted in 1949 providing a framework for regulation and supervision of commercial banking activity. The first step towards the nationalisation of commercial banks was the result of a report (under the aegis of RBI) by the *Committee of Direction of All India Rural Credit Survey* (1951) which till today is the *locus classicus* on the subject. The Committee recommended one strong integrated state partnered commercial banking institution to stimulate banking development in general and rural credit in particular. Thus, the Imperial Bank was taken over by the Government and renamed as the State Bank of India (SBI) on July 1, 1955 with the RBI acquiring overriding substantial holding of shares. A number of erstwhile banks owned by princely states were made subsidiaries of SBI in 1959. Thus, the beginning of the Plan era also saw the emergence of public ownership of one of the most prominent of the commercial banks. There was a feeling that though the Indian banking system had made considerable progress in the '50s and '60s, it established close links between commercial and industry houses, resulting in cornering of bank credit by these segments to the exclusion of agriculture and small industries.

To meet these concerns, in 1967, the Government introduced the concept of *social control* in the banking industry. The scheme of social control was aimed at bringing some changes in the management and distribution of credit by the commercial banks. The close link between big business houses and big banks was intended to be snapped or at least made ineffective by the reconstitution of the Board of Directors to the effect that 51 per cent of the directors were to have special knowledge or practical experience. Appointment of whole-time Chairman with special knowledge and practical experience of working of commercial banks or financial or economic or business administration was intended to professionalise the top management. Imposition of restrictions on loans to be granted to the directors' concerns was another step towards avoiding undesirable flow of credit to the units in which the directors were interested. The scheme also provided for the take-over of banks under certain circumstances.

Political compulsion then partially attributed to inadequacies of the social control, led to the Government of India nationalising, in 1969, 14 major scheduled commercial banks which had deposits above a cut-off size. The objective was to serve better the needs of development of the economy in conformity with national priorities and objectives. In a somewhat repeat of the same experience, eleven years after nationalisation, the Government announced the nationalisation of six more scheduled commercial banks above the cut-off size. The second round of nationalisation gave an impression that if a private sector bank grew to the cut-off size it would be under the threat of nationalisation.

From the fifties a number of exclusively state-owned development financial institutions (DFIs) were also set up both at the national and state level, with a lone exception of Industrial Credit and Investment Corporation (ICICI) which had a minority private share holding. The mutual fund activity was also a virtual monopoly of Government owned institution, viz., the Unit Trust of India. Refinance institutions in agriculture and industry sectors were also developed, similar in nature to the DFIs. Insurance, both Life and General, also became state monopolies.

Pre-reform status

The regulatory framework for the banking industry under the Banking Regulation Act was circumscribed by the special provisions of the Bank Nationalisation Act both of which had elements of corporate governance incorporated with regard to composition of Board of Directors in terms of representation of directors, etc. While technically there was competition between banks and non-banks and among banks, substantively, competition was conditioned by policy as well as regulatory environment, common ownership by the Government and agreement between the Government of India as an owner and the workers represented by the Unions. Subsequent efforts during the reform period in terms of hesitancy in permitting industrial houses as well as foreign owned banks should be viewed in this historical context.

As regards the policy environment, it must be recognised that almost the whole of financial intermediation was on account of public sector, with PSBs being the most important source of mobilisation of financial savings. Resources for DFIs were also made available either by banks or mostly created money and governmental support. The major thrust was on expansion of banks' branches, provision of banking services and mobilisation of deposits. The interest rate regime was administered with interest rates fixed both on deposits and lending. At the same time, there was large pre-emption of banks' resources under the cash reserve ratio or in the form of statutory liquidity ratio. The delivery of credit was also by and large directed through an allocative mechanism or as an adjunct to the licensing regime. In the process, the private sector banks tended to be confined to the local areas and were unable to expand in such an environment. Banks, mainly public sector banks became the most dominant vehicle of the financial intermediation in the country. To a large extent, entry was restricted and exit was impossible and there was little or no scope for functions of risk assessment and pricing of risks. The Government, thus combined in itself the role of owner, regulator and sovereign.

The legal as well as policy framework emphasised co-ordination in the interest of national development as per Plan priorities with the result, the issue of corporate governance became subsumed in the overall development framework. To the extent each bank, even after nationalization, maintained its distinct identity, governance structure as incorporated in the concerned legislations provided for a formal structure of relationship between the RBI, Government, Board of Directors and management. The role of the RBI as a regulator became essentially one of being an extended arm of the Government so far as highest priority was accorded to ensuring coordinated actions in regard to activities particularly of PSBs. The SBI, which was owned by the RBI, was in substance no different from the other banks owned by the Government in terms of Board composition, appointment procedures of the executives and non-executive members of the Board of Directors. Both Government and RBI were represented on the Board of Directors of the PSBs. There has been significant cross representation in terms of owner or lender and in other relationships between banks and all other major financial entities. In other words, cross holdings and inter-relationships were more a rule than an exception in the financial sector, since the basic objective was coordination for ensuring planned development, with the result, the concepts of conflicts of interests among players, checks and balances etc., were subordinated to the social goals of the *joint family* headed by the Government.

Reform measures

The major challenge of the reform has been to introduce elements of market incentive as a dominant factor gradually replacing the administratively coordinated planned actions for development. Such a paradign shift has several dimensions, the corporate governance being one of the important elements.

The evolution of corporate governance in banks, particularly, in PSBs, thus reflects changes in monetary policy, regulatory environment, and structural transformations and to some extent, on the character of the self-regulatory organizations functioning in the financial sector.

Policy environment

During the reform period, the policy environment enhanced competition and provided greater opportunity for exercise of what may be called genuine corporate element in each bank to replace the elements of coordinated actions of all entities as a "joint family" to fulfill predetermined Plan priorities. The measures taken so far can be summarized as follows:

First, greater competition has been infused in the banking system by permitting entry of private sector banks (9 licences since 1993), and liberal licensing of more branches by foreign banks and the entry of new foreign banks. With the development of a multi-institutional structure in the financial sector, emphasis is on efficiency through competition irrespective of ownership. Since non-bank intermediation has increased, banks have had to improve efficiency to ensure survival.

Second, the reforms accorded greater flexibility to the banking system to manage both the pricing and quantity of resources. There has been a reduction in statutory preemptions to less than a third of commercial banks resources. The mandatory component of market financing of Government borrowing has decreased. While directed credit continues it is now on near commercial terms. Valuation of banks' investments is also attuned to international best practices so as to appropriately capture market risks.

Third, the RBI has moved away from micro-regulation to macro-management. RBI has replaced detailed individual guidelines with general guidelines and now leaves it to individual banks' boards to set their guidelines on credit decisions. A Regulation Review Authority was established in RBI, whereby any bank could challenge the need for any regulation or guideline and the department had to justify the need and usefulness for such guideline relative to costs of regulation and compliance.

Fourth, to strengthen the banking system to cope up with the changing environment, prudential standards have been imposed in a progressive manner. Thus, while banks have greater freedom to take credit decisions, prudential norms setting out capital adequacy norms, asset classification, income recognition and provisioning rules, exposure norms, and asset liability management systems have helped to identify and contain risks, thereby contributing to greater financial stability.

Fifth, an appropriate legal, institutional, technological and regulatory framework has been put in place for the development of financial markets. There is now increased volumes and transparency in the primary and secondary market operations. Development of the Government Securities, money and forex markets has improved the transmission mechanism of monetary policy, facilitated the development of an yield curve and enabled greater integration of markets. The interest rate channel of monetary policy transmission is acquiring greater importance as compared with the credit channel.

Regulatory environment

Prudential regulation and supervision have formed a critical component of the financial sector reform programme since its inception, and India has endeavoured to international prudential norms and practices. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Bank exposures to sensitive sectors such as equity and real estate have been curtailed. The Banking Regulation Act 1949 prevents connected lending (i.e. lending by banks to directors or companies in which Directors are interested).

Periodical inspection of banks has been the main instrument of supervision, though recently there has been a move toward supplementary 'on-site inspections' with 'off-site surveillance'. The system of 'Annual Financial Inspection' was introduced in 1992, in place of the earlier system of Annual Financial Review/Financial Inspections. The inspection objectives and procedures, have been redefined to evaluate the bank's safety and soundness; to appraise the quality of the Board and management; to ensure compliance with banking laws & regulation; to provide an appraisal of soundness of the bank's assets; to analyse the financial factors which determine bank's solvency and to identify areas where corrective action is needed to strengthen the institution and improve its performance. Inspection based upon the new guidelines have started since 1997.

A high powered Board for Financial Supervision (BFS), comprising the Governor of RBI as Chairman, one of the Deputy Governors as Vice-Chairman and four Directors of the Central Board of RBI as members was constituted in 1994, with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies.

A supervisory strategy comprising on-site inspection, off-site monitoring and control systems internal to the banks, based on the CAMELS (capital adequacy, asset quality, management, earnings, liquidity and systems and controls) methodology for banks have been instituted. The RBI has instituted a mechanism for critical analysis of the balance sheet by the banks themselves and the presentation of such analysis before their boards to provide an internal assessment of the health of the bank. The analysis, which is also made available to the RBI, forms a supplement to the system of off-site monitoring of banks.

Keeping in line with the merging regulatory and supervisory standards at international level, the RBI has initiated certain macro level monitoring techniques to assess the true health of the supervised institutions. The format of balance sheets of commercial banks have now been prescribed by the RBI with disclosure standards on vital performance and growth indicators, provisions, net NPAs, staff productivity, etc. appended as 'Notes of Accounts'. To bring about greater transparency in banks' published accounts, the RBI has also directed the banks to disclose data on movement of non-performing assets (NPAs) and provisions as well as lending to sensitive sectors. These proposed additional disclosure norms would bring the disclosure standards almost on par with the international best practice.

Structural environment of banking

The nationalized banks are enabled to dilute their equity of Government of India to 51% following the amendment to the Banking Companies (Acquisition & Transfer of Undertakings) Acts in 1994, bringing down the minimum Government's shareholdings to 51 per cent in PSBs. RBI's shareholding in SBI is subject to a minimum of 55 per cent. Ten banks have already raised capital from the market. The Government proposed, in the Union Budget for the financial year 2000-01 to reduce its holding in nationalised banks to a minimum of 33 per cent, while maintaining the public sector character of these banks. The diversification of ownership of PSBs has made a qualitative difference to the functioning of PSBs since there is induction of private shareholding and attendant issues of shareholder’s value, as reflected by the market cap, representation on board, and interests of minority shareholders. There is representation of private shareholder when the banks raise capital from the market.

The governance of banks rests with the board of directors. In the light of deregulation in interest rates and the greater autonomy given to banks in their operations, the role of the board of directors has become more significant. During the years, Boards have been required to lay down policies in critical areas such as investments, loans, asset-liability management, and management and recovery of NPAs. As a part of this process, several Board level committees including the Management Committee are required to be appointed by banks.

In 1995, the RBI directed banks to set up Audit Committees of their Boards, with the responsibility of ensuring efficacy of the internal control and audit functions in the bank besides compliance with the inspection report of the RBI, internal and concurrent auditors. To ensure both professionalism and independence, the Chartered Accountant Directors on the boards of banks are mandatory members, but the Chairman would not be part of the Audit Committee. Apart from the above, Board level committees that are required to be set up are Risk Management committee, Asset Liability Management committee (ALCO), etc. The Boards have also been given the freedom to constitute any other committees, to render advice to it.

Government introduced a Bill in Parliament to omit the mandatory provisions regarding appointment of RBI nominees on the Boards of public sector banks and instead to add a clause to enable RBI to appoint its nominee on the boards of public sector banks if the RBI is of the opinion that in the interest of the banking policy or in the public interest or in the interest of the bank or depositors, it is necessary so to do.

As regards, appointment of Additional Directors on the Boards of private sector banks, since December 1997, the RBI has been appointing such directors only in such of those 'banks making losses for more than one year, having CRAR below 8%, NPAs exceeding 20% or where there are disputes in the management.

Appointment of Chairman and Managing Directors and Executive Directors of all PSBs is done by Government. The Narasimham Committee II had recommended that the appointment of Chairman and Managing Director should be left to the Boards of banks and the Boards themselves should be elected by shareholders. Government has set up an Appointment Board chaired by Governor, Reserve Bank of India for these appointments. More recently, in case of appointment of Chief Executive Officer of the PSBs identified as weak, the Government has formed a Search Committee with two outside experts.

Appointment as well as removal of auditors in PSBs require prior approval of the RBI. There is an elaborate procedure by which banks select auditors from an approved panel circulated by the RBI. In respect of private sector banks, the statutory auditors are appointed in the Annual General Meeting with the prior approval by the RBI.

Self regulatory organizations

India has had the distinction of experimenting with Self Regulatory Organisations (SROs) in the financial system since the pre-independence days. At present, there are four SROs in the financial system - Indian Banks Association (IBA), Foreign Exchange Dealers Association of India (FEDAI), Primary Dealers Association of India (PDAI) and Fixed Income Money Market Dealers Association of India (FIMMDAI).

The IBA established in 1946 as a voluntary association of banks, strove towards strengthening the banking industry through consensus and co-ordination. Since nationalisation of banks, PSBs tended to dominate IBA and developed close links with Government and RBI. Often, the reactive and consensus and coordinated approach bordered on cartelisation. To illustrate, IBA had worked out a schedule of benchmark service charges for the services rendered by member banks, which were not mandatory in nature, but were being adopted by all banks. The practice of fixing rates for services of banks was consistent with a regime of administered interest rates but not consistent with the principle of competition. Hence, the IBA was directed by the RBI to desist from working out a schedule of benchmark service charges for the services rendered by member banks.

Responding to the imperatives caused by the changing scenario in the reform era, the IBA has, over the years, refocused its vision, redefined its role, and modified its operational modalities.

In the area of foreign exchange, FEDAI was established in 1958, and banks were required to abide by terms and conditions prescribed by FEDAI for transacting foreign exchange business. In the light of reforms, FEDAI has refocused its role by giving up fixing of rates, but plays a multifarious role covering training of banks' personnel, accounting standards, evolving risk measurement models like the VaR and accrediting foreign exchange brokers.

In the financial markets, the two SROs, viz., the PDAI and the FIMMDAI are of recent origin i.e. 1996 and 1997. These two SROs have been proactive and are closely involved in contemporary issues relating to development of money and government securities markets. The representatives of PDAI and FIMMDAI are members of important committees of the RBI, both on policy and operational issues. To illustrate, the Chairmen of PDAI and FIMMDAI are members of the Technical Advisory Group on Money and Government Securities market of the RBI. These two SROs have been very proactive in mounting the technological infrastructure in the money and Government Securities markets. The FIMMDAI has now taken over the responsibility of publishing the yield curve in the debt markets. Currently, the FIMMDAI is working towards development of uniform documentation and accounting principles in the repo market.

Assessment of corporate governance in PSBs

A Standing Committee on International Financial Standards and Codes was constituted to, *inter alia*, assess the status in India *vis-à-vis* the best global practices in regard to standards and codes. An Advisory Group on Corporate Governance (Chairman: Dr. R. H. Patil) made detailed assessment and gave recommendations of which those relating to PSBs is an important component. The Report provides the most comprehensive set of recommendations on the subject, summarised in Box 1.

Box 1
Advisory Group on Corporate Governance

- Currently in India, about four-fifths of the banking business is under the control of public sector banks (PSBs), comprising the SBI and its subsidiaries and the nationalised banks. Corporate governance in PSBs is complicated by the fact that effective management of these banks vests with the government and the top managements and the boards of banks operate merely as functionaries. The ground reality is such that the government performs simultaneously multiple functions *vis-à-vis* the PSBs, such as the owner, manager, quasi-regulator, and sometimes even as the super-regulator. Unless the issues connected with these multiple, and sometimes conflicting, functions are resolved and the boards of banks are given the desired level of autonomy it would be difficult to improve the quality of corporate governance in PSBs. One of the major factors that impinge directly on the quality of corporate governance is the government ownership. It is desirable that all the banks are brought under a single Act so that the corporate governance regimes do not have to be different just because the entities are covered under multiple Acts of the Parliament or that their ownership is in the private or public sector.

- Even when the government dilutes its holdings to bring them significantly below the threshold limit of 51 per cent, efforts to institute good governance practices would remain at superficial level unless the government seriously redefines its role *de novo*. The changes proposed in the composition of the boards as per legislation under contemplation would result in government directly appointing 9 out of the 15 directors including the 4 whole time directors. Moreover, the voting rights of any of the other shareholders will continue to be restricted, thereby negating the basic principle of equal rights to all the shareholders. The rights of private shareholders' of SBI/PSBs are abridged considerably, since their approval is not required for paying dividend or adopting annual accounts. The subsidiaries of the SBI enjoy very limited board autonomy as they have to get clearance on most of the important matters from the parent even before putting them up to their boards. Further, as things stand today, there is no equality among the various board members of the PSBs. Nominees of RBI and Government are treated to be superior to other directors.

- Another major problem affecting banks has been the representation given to the various interest groups on the boards of the banks. The main objective behind these representations was to give voice to various sections of the society at the board level of the banks. Hence, a major reform is needed in the area of constitution of the boards of the banks. The Chairmen, Executive Directors and non-executive directors on the boards of the PSBs (including the SBI and its subsidiaries) need to be appointed on the advice of an expert body set up on the lines of the UPSC, with similar status and independence. Such a body may be set up jointly by RBI and the Ministry of Finance. There is also no need to have directors that represent narrow sectional and economic interests. All the objectives that the banks are supposed to achieve should become an integral part of the corporate mission statements of these institutions.

- Although RBI maintains a tight vigil and inspects these entities thoroughly at regular time intervals, the quality of corporate level governance mechanism does not appear to be satisfactory. In its role as the regulator, RBI need not have representation on the bank boards, given the fact that it leads to conflicts of interests with its regulatory functions. This should apply even in the case of SBI where RBI is the major shareholder. Further, any policy measures to protect banks that are less careful in their lending policies at the cost of tax payers' money need to be tempered in such a way that they do not encourage profligate lending by banks.

- Current regulatory provisions do not permit a bank to lend money to a company if any of its board members is also a director on the board of that company. The negative impact of this rule has been that the banks are not able to get good professionals for their boards. This archaic rule should be modified immediately so that the professionals who are on the boards of non-banking companies as professional or independent directors do not suffer from any handicaps. The current rule may, however, be continued only in respect of directors of companies who are their promoters and have a stake in their companies beyond being merely a director. In the interest of good governance, it is desirable that government directors should not participate in the discussion on such matters and also abstain from voting.

The Report of the Advisory Group on Banking Supervision (Chairman : Mr. M.S. Verma) has also made some recommendations on corporate governance, which are summarised in Box 2.

Box 2
Advisory Group on Banking Supervision

- The quality of corporate governance should be the same in all types of banking organisations irrespective of their ownership. The process of induction of directors into banks' boards and their initial orientation may be streamlined. Banks need to develop mechanisms, which can help them ensure percolation of their strategic objectives and corporate values throughout the organisation. Boards need to set and enforce clear lines of responsibility and accountability for themselves as well as the senior management and throughout the organisation. Linkage between contribution and remuneration/reward should be established. Compensation Committees of the board could be set up for the purpose. Nomination Committees to assess the effectiveness of the board and direct the process of renewing and replacing board members are desirable. Disclosures in respect of committees of the board and qualifications of the directors, incentive structure and the nature and extent of transactions with affiliated and related parties need to be encouraged. Finally, a provision on the lines of Section 20 of the Banking Regulation Act, 1949, which prohibits loans and advances to directors and their connected parties, will have to be made in respect of large shareholders also. Information on transactions with affiliated and related parties should be disclosed.

Current proposal

It would be evident that the Reports of Advisory Groups contain far reaching proposals to improve corporate governance and many, if not all, do require legislative processes and they are necessarily time consuming and often realizable only in medium-term. While proceeding with analysis and possible legislative actions, it may be necessary to consider and adopt changes that could be brought about within the existing legislative framework.

To this end, Governor Jalan in his Monetary and Credit Policy Statement of October 2001 constituted a Consultative Group of Directors of banks and financial institutions (Chairman Dr. A.S. Ganguly) to review the supervisory role of Boards of banks and financial institutions and to obtain feedback on the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees etc. and make recommendations for making the role of Board of Directors more effective. The Group made its recommendations very recently after a comprehensive review of the existing framework as well as of current practices and benchmarked its recommendations with international best practices as enunciated by the Basel Committee on Banking Supervision, as well as of other committees and advisory bodies, to the extent applicable in the Indian environment. The report has been put in public domain for a wider debate and its major recommendations are summarized in Box 3 :

Box 3
Report of the Consultative Group of Directors of Banks/Financial Institutions

- On appointment of Directors, due diligence of the directors of all banks – be they in public or private sector, should be done in regard to their suitability for the post by way of qualifications and technical expertise. Involvement of Nomination Committee of the Board in such an exercise should be seriously considered as a formal process. Further, the Government while nominating directors on the Boards of public sector banks should be guided by certain broad "fit and proper" norms for the Directors. The criteria suggested by the Bank for International Settlements (BIS) may be suitably adopted for considering "fit and proper" test for bank directors.
- In the present context of banking becoming more complex and knowledge-based, there is an urgent need for making the Boards of banks more contemporarily professional by inducting technical and specially qualified individual. While continuing regulation based representation of sectors like agriculture, SSI, cooperation, etc., the appointment/nomination of independent/ non-executive directors to the Board of banks (both public sector and private sector) should be from a pool of professional and talented people to be prepared and maintained by RBI. Any deviation from this procedure by any bank should be with the prior approval of RBI.

- On the functioning, the independent/non-executive directors should raise in the meetings of the Board, critical questions relating to business strategy, important aspects of the functioning of the bank and investor relations. In the case of private sector banks where promoter directors may act in concert, the independent/non-executive directors should provide effective checks and balances ensuring that the bank does not build up exposures to entities connected with the promoters or their associates. The independent/non-executive directors should provide effective checks and balances particularly, in widely held and closely controlled banking organizations.
- As a step towards effective corporate governance, it would be desirable to take an undertaking from every director to the effect that they have gone through the guidelines defining the role and responsibilities of directors, and understood what is expected of them and enter into a covenant to discharge their responsibilities to the best of their abilities, individually and collectively.
- In order to attract quality professionals, the level of remuneration payable to the directors should be commensurate with the time required to be devoted to the bank's work as well as to signal the appropriateness of remuneration to the quality of inputs expected from a member. The statutory prohibition under section 20 of the Banking Regulation Act, 1949 on lending to companies in which the director is interested, severely constricts availability of quality professional directors on to the Boards of banks. This would require a change in the existing legal framework. We need to move towards this goal.
- It would be desirable to separate the office of Chairman and Managing Director in respect of large sized public sector banks. This functional separation will bring about more focus on strategy and vision as also the needed thrust in the operational functioning of the top management of the bank. The directors could be made more responsible to their organization by exposing them to an induction briefing need-based training programme/seminars/workshops to acquaint them with emerging developments/challenges facing the banking sector. RBI as the regulator, could take the initiative to organizing such seminars. RBI may bring out an updated charter indicating clear-cut, specific guidelines on the role expected and the responsibilities of the individual directors. The whole-time directors should have sufficiently long tenure to enable them to leave a mark of their leadership and business acumen on the bank's performance. All banks should consider appointing qualified Company Secretary as the Secretary to the Board and have a Compliance Officer (reporting to the Secretary) for monitoring and reporting compliance with various regulatory/accounting requirements.
- The information furnished to the Board should be wholesome, complete and adequate to take meaningful decisions. A distinction needs to be made between statutory items and strategic issues in order to make the material for directors 'manageable'. The Reviews dealing with various performance areas could be put up the Supervisory Committee of Board and a summary of each such review could be put up to the Main Board. The Board's focus should be devoted more on strategy issues, risk profile, internal control systems, overall performance, etc. The procedure followed for recording of the minutes of the board meetings in banks and financial institutions should be uniform and formalized. Banks and financial institutions may adopt two methods for recording the proceedings viz., a summary of key observations and a more detailed recording of the proceedings.
- It would be desirable if the exposures of a bank to stockbrokers and market-makers as a group, as also exposures to other sensitive sectors, viz., real estate etc. are reported to the Board regularly. The disclosures in respect of the progress made in putting in place a progressive risk management system, the risk management policy, strategy followed by the bank, exposures to related entities, the asset classification of such lendings/investments etc. conformity with Corporate Governance Standards etc., be made by banks to the Board of Directors at regular intervals as prescribed.
- As regards Committees, there could be a Supervisory Committee of the Board in all banks, be the public or private sector, which will work on collective trust and at the same time, without diluting the overall responsibility of the Board. Their role and responsibilities could include monitoring of the exposures (credit and investment) review of the adequacy of risk management process and upgradation thereof, internal control systems and ensuring compliance with the statutory/regulatory framework. The Audit Committee should, ideally be

constituted with independent/non-executive directors and the Executive Director should only be a permanent invitee. However, in respect of public sector banks, the existing arrangement of including the Executive Director and nominee directors of Government and RBI in the Audit Committee may continue. The Chairman and Audit Committee need not be confined to the Chartered Accountant profession but can be a person with knowledge on 'finance' or 'banking' so as to provide directions and guidance to the Audit Committee, since the Committee not only looks at accounting issues, but also the overall management of the bank. It is desirable to have a Nomination Committee for appointing independent/non-executive directors of banks. In the context of a number of public sector banks issuing capital to the public, a Nomination Committee of the Board may be formed for nomination of directors, representing shareholders. The formation and operationalisation of the Risk Management Committees in pursuance of the guidelines issued by the RBI should he speeded up and their role further strengthened. With a view of building up credibility among the investor class, the Group recommends that a Committee of the Board may be set up to look into the grievance of investors and shareholders, with the Company Secretary as a nodal point.

- Finally the banks could be asked to come up with a strategy and plan for implementation of the governance standards recommended and submit progress of implementation, for review after twelve months and thereafter half yearly or annually, as deemed appropriate.

Tentative issues and lessons

The Indian experience shows recognition of (a) the importance of corporate governance and the challenges in redefining institutional relations in the financial sector in respect of PSBs; (b) the need for a broader view of enhancing corporate governance to take account of law and policy as well as the operating and institutional environment; and (c) the desirable changes in the composition and functioning of the board. The processes by which some progress has been made so far and actions contemplated are also instructive – needless to add that these issues and lessons have to be viewed as tentative, and of course, contextual.

Corporate governance in PSBs is important, not only because PSBs happen to dominate the banking industry, but also because, they are unlikely to exit from banking business though they may get transformed. To the extent there is public ownership of PSBs, the multiple objectives of the government as owner and the complex principal-agent relationships cannot be wished away. PSBs cannot be expected to blindly mimic private corporate banks in governance though general principles are equally valid. Complications arise when there is a widespread feeling of uncertainty of the ownership and public ownership is treated as a transitional phenomenon. The anticipation or threat of change in ownership has also some impact on governance, since expected change is not merely of owner but the very nature of owner. Mixed ownership where government has controlling interest is an institutional structure that poses issues of significant difference between one set of owners who look for commercial return and another who seeks something more and different, to justify ownership. Furthermore, the expectations, the reputational risks and the implied even if not exercised authority in respect of the part-ownership of government in the governance of such PSBs should be recognized. In brief, the issue of corporate governance in PSBs is important and also complex.

The most important challenge faced in enhancing corporate governance and in respect of which there has been significant though partial success relates to redefining the interrelationships between institutions within the broadly defined public sector i.e., government, RBI and PSBs to move away from "joint family" approach originally designed for a model of planned development. As part of reform the government had to differentiate, conceptually and at the policy level, its role as sovereign, owner of banks and overarching supervisor of regulators including RBI. The central bank also had to move away from sharing the nitty gritty of developmental schemes with government involving micro regulation, to a more equitable treatment of all banks as regulator and supervisor. Furthermore, the bureaucracy of RBI is accountable to the RBI's Board for Financial Supervision. The large publicly owned non-financial enterprise had to recognize the need for a more commercial and competitive approach with banks including PSBs in raising of and deployment of funds. Similarly, the PSBs had to reorient their approach to each other also with intensified competition engineered by policy while guarding against excessive risk taking as dictated by a supervisor seeking to meet international standards.

Another noteworthy aspect of enhancing corporate governance is the narrowing of gap between PSBs and other banks in terms of the policy, regulatory and operating environment, apart from some changes in ownership structures with attendant consequences. The PSBs as hundred per cent owned entities with no share value quoted in stock exchanges accounted for over three quarters of banking business seven years ago, while they now account for less than a quarter.

A third area where a few changes to enhance quality of governance have been made or are contemplated relates to the manner in which chief executives are selected, the board is composed in view of induction of some elected directors, and the constitution of committees, including the Audit Committee. In this regard, it is noteworthy that recently, the functioning of bank boards in the private sector seems to have attracted significant adverse notice, both from market and supervisor. That the representation of RBI on the Boards is not desirable has been conceded just as RBI has expressed interest in divesting all its ownership functions.

The processes by which these changes have been and are being brought about may also be of some interest. First, RBI has taken initiative in bringing about changes rather than “keep aloof” from the regulated entities as pure theory may suggest. The developmental role of RBI, which was in the nature of promoting and funding of institutions or channeling credit to schemes under government approved plans has yielded place to the role of developer of a more robust financial system, especially banking structure and system. Sometimes, closer involvement of RBI in some transitional arrangements, such as in advising government on appointment of Chief Executives of PSBs was needed to bring about changes. The professional inputs as well as sensitising and creating opinion to enhance corporate governance was ensured by RBI through the Advisory Groups and Consultative Group mentioned.

Second, as Governor Jalan in his National Institute of Bank Management (NIBM) Annual Day Lecture articulated, markets are more free and more complex now; what happens in banks is a concern for all since there is fear of contagion and above all we live in a more volatile and interlinked world where effects are instantaneous. (Jalan 2002). Hence, in the process of making markets more free as part of the reform, RBI had to discharge its responsibility of equipping the participants, especially the most dominant segment viz., PSBs, to manage the complexities or simply to cope. Hence, RBI had taken initiatives in improving the competitive strengths as well as governance systems of PSBs while pursuing its objective of distancing, as a regulator, from the operational closeness with both government which is an owner of PSB, and PSBs which are the regulated.

Thirdly, the path of reform of which corporate governance is one element had to be considered carefully and evolved through a consultation and participation process at every step. Thus, the basic framework was provided by Narasimham Committees 1 and 2 in which all stakeholders were represented followed by a series of Committees and Consultation Papers to refine and redefine and apply the basic framework. The collaborative and consensual approach in the path of reform was adopted while the goals of reforms were to the extent possible well defined. The most recent example of this approach has been described in the Report of the Advisory Groups on various International Standards and Codes.

Fourthly, there was need to resist the temptation of demoralising the PSBs on presumed inefficiency, and make every effort to enable and empower them to meet the challenges. There has been clear recognition that governance is not merely one of structures, but also one of culture and this requires careful nurture. This has been made possible by a variety of mechanisms and through a variety of fora. One illustration would suffice to reflect the changing attitude of the RBI in this regard. The Governor, RBI who was the Chairman of National Institute of Bank Management yielded the position to a former Chairman of a public sector bank and the RBI distanced itself from the day to day running of the Institute without withdrawing its interest and support.

Fifthly, the importance of SROs in bringing about change has been recognised and the orientation of pre-existing institutions, in particular, Indian Banks’ Association, has changed to meet new challenges. Various mechanisms have been found to ensure an environment supportive of sound corporate governance mentioned in BIS Document (BIS September 1999) by not only pursuing legal and policy changes with the Government, but also close interaction with auditors and banking industry associations.

Random thoughts

The Indian experience provokes some thoughts on a few fundamental issues in regard to PSBs and corporate governance. First, is public ownership compatible with sound corporate governance as generally understood? Since various corporate governance structures exist in different countries, there are no universally correct parameters of sound corporate governance. Government ownership of a bank, unless government happens to have such a stake purely as a financial investment for return, necessarily has to have the effect of altering the strategies and objectives as well as structure of governance. Government as an owner is accountable to political institutions which may not necessarily be compatible with purely economic incentives. The mixed ownership brings into sharper focus the divergent objectives of shareholding and the issues of reconciling them, especially when one of the owners is government. In such a situation, one can argue that as long as the private shareholder is aware of the special nature of shareholding, there should be no conflict. In other words, the idea of maintaining public sector character of a bank while government holds a minority shareholding is an intensified and modified version of “golden share” experiment of U.K. The question could still be as to whether such a mixed ownership is the most efficient form of organization, particularly for banks which are in any case generally under intense regulation and supervision.

Second, is corporate governance generally better in private sector, in particular, private sector banks? In regard to old private sector banks (i.e. founded in pre-reform era, almost all of them continue to be closely held and many of them resist broadening their shareholder base and thus avoid deepening of corporate structures. More often than not, takeover bids have been by equally closely held groups. As regards new private sector banks, which have been licensed after close scrutiny in the reform period, the promotees were expected to dilute their stakes to below 40 per cent within three years. In two of the cases, this is yet to happen, while in most cases, the banks continue to be identified with effective controlled by promoter institutions. Governor Jalan, made an interesting observation on this in a recent lecture. “By and large, the structure is very weak in Co-operatives and NBFCs for historical reasons, local practices, and multiplicity of regulators and laws. Old private sector banks also have very poor auditing and accounting systems. New private banks – generally good on accounting, but poor on accountability. More modern and computerized, but less risk conscious. One thing which is common to all is that corporate governance is highly centralized with very little real check on the CEO, who is generally also closely linked to the largest owner groups. Boards or auditing systems are not very effective.” (Jalan 2002)

Third, how do the dynamics of insider and outsider models in terms of separation between ownership and management work in public vis-à-vis private sector banks? One view is that there is not much difference between public and private sectors in India. “The literature on the governance deals mostly with the financial disclosures and restrictions on the managements that remain within the corporation and the influence that the external stakeholder or shareholders can hold. But in developing countries, the problem is slightly the other way round. In developing countries and more particularly in India, the major corporate issue is not how outside financiers can control the actions of the managers but also how outside stakeholders including the minority shareholders can exert control over the big inside shareholders; and this does not apply only to the public sector, but it applies equally strongly or probably more strongly to the private sector as well.” (Bhide 2002).

There are, however, significant elements of subjectivity. Governor Jalan feels that private sector has greater elements of insider model. “Public sector banks/FIs, for example, are more akin to the ‘outsider’ model with separation of “Ownership” and “Management”. Private sector banks/NBFCs/Co-ops - much more “insider” models with families, inter-connected entities or promoters running the management.” (Jalan 2002)

The dominant view, backed by more recent research is that the issue in India often relates to minority shareholder. “Rather than conflict between owners and managers of firms, it is the conflict between the interests of minority shareholders and promoters (say business groups) that is more relevant for India and that needs to be addressed. “ (NSE 2001). In other words, if the governance structures are weak, the risks of private ownership of banks need to be assessed before embarking on large scale privatizations.

Fourth, is the performance of PSBs vis-à-vis private sector demonstrably better? The evidence here is not conclusive, because comparison is beset with several difficulties. Clearly, old private sector banks as a group do not perform well, while new private sector banks show good performance as a group better than the PSBs as a group. Given the size and variety of PSBs, it is possible to find banks that could equal the good private sector banks as well as bad ones. In addition, PSBs have to reckon the “legacy” problems, such as the non performing assets that they are saddled with. Some PSBs operate in relatively backward areas with limited discretion for management to pull out from such areas. The question still remains: whether there is a better pay off in enabling PSBs to improve their performance while promoting private sector banks compared to transfer of ownership and control from public to private sector? Will greater scope for mergers and acquisitions within and between public and private sector add to greater efficiency than treating public and private in a watertight manner?

Finally, what should be the most operationally relevant approach for enhancing governance in PSBs recognizing that the extent of public ownership is determined predominantly by considerations of political economy while the functioning of institutions could possibly be influenced by techno-economic factors. The Indian experience so far, including identified agenda for debtate, seems to indicate that, clear cut demarcation of responsibilities of various institutions and participants is critical since "joint family approach" needs to be ended with friendly but amicable "partition" of assets, liabilities and activities. This needs to be accompanied by transparency in dealing with each other and proper accounting of transactions which would be significantly in the areas of managerial reporting and financial accounting. Simultaneously, checks and balances should be consciously put in place to replace the tradition of all pervading bureaucratic coordination.

In brief, central bank has a developmental role even in the period of reform but it is a different type of role, namely not directly financing development but help develop systems, institutions and procedures to enable a paradigm shift in public policy and in the process enhance corporate governance also in PSBs, in particular. While legislative changes are necessary for an enduring improvement in corporate governance and such legislative changes are not easy to effect in a democratic multi-party Parliamentary system, it is reassuring to observe that significant improvements in corporate governance in the Indian financial sector are being effected even within the existing legislative framework.