# Y V Reddy: Corporate governance in banks in India

Luncheon address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Seminar on Corporate Governance for Bank Directors organised by the Indian Institute of Management, Bangalore; International Institute of Finance, Washington and the Indian Banks' Association, Mumbai, 16 December 2005.

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Friends,

I am thankful to the organisers for inviting me to give a luncheon address. There are several reasons why I was compelled to accept the responsibility. First, the eminence of the presentors, namely Indian Institute of Management, Bangalore, International Institute of Finance and Indian Banks' Association. Second, the persuasive skills of Mr. Sinor who brings to bear the persona of the whole banking community on any subject. Third, growing importance being accorded to governance in banks by the Reserve Bank of India (RBI) in recent years. This is a program addressed to Bank Directors of Indian banks and RBI would like to be seen to be supportive of efforts to equip the Directors of banks to address the commercial-cum-governance issues in general and fulfil the fiduciary responsibilities implicit in being on the boards of banks, in particular. Since many substantive aspects of the subject are being addressed by highly qualified professionals, I will initially make a few general observations on the subject but will devote the rest to an enumeration of the Reserve Bank's recent initiatives and some thoughts on way forward.

## General observations

As you are aware, corporate governance, as a subject of significance for both public policy and markets, is of recent origin. It is useful to recognise that it is a dynamic concept, in terms of scope, thrust and relevance. For example, the issue is approached very differently today compared to original view of the Cadbury Committee on the subject. East-Asian crisis gave a new dimension to corporate governance in the context of financial stability. In U.S.A., the regulatory regimes, post-corporate scandals, are very different from those of the early 90's. The OECD set out its corporate governance principles in 1999 but revised them in 2004. Basel Committee on Banking Supervision (under the aegis of the BIS) published guidelines on corporate governance in banks in 1999. As an update, in July 2005, the Basel Committee has issued a Consultative Document on enhancing corporate governance for banking organisations, seeking comments by end October 2005. I would advise that this document for now and the final document when released by BIS, should be a compulsory reading for all the regulators concerned and all the directors on the boards of the banks. The point to be noted is that corporate governance should be viewed as an ongoing process subject to rapid changes based on experiences, developments and policy-setting.

There is considerable divergence in the understanding and practice of corporate governance in general, and in respect of banks, in particular, but there is also an increasing tendency towards convergence. The cultural context may be difficult to capture but the legal, institutional and attitudinal contexts do vary perceptibly across countries. Differences can be noticed even amongst the industrialised countries – say between Anglo-Saxon, European and Japanese situations. At the same time, the trend towards greater convergence is for several reasons. The corporates are getting listed in multiple stock exchanges in different countries and carry out corporate operations in several jurisdictions while the cross-border financial flows seek an assurance of some commonly understood standards of governance, which have a mutually reinforcing tendency. Banks, in particular, have been a subject of special interest for governance, especially in view of their fiduciary role. The cross-border operations of banks provide an added impetus for convergence in such standards.

Public policy framework in regard to corporate governance typically involves multiplicity of agencies in all countries. For instance, in India, these are Department of Company Affairs; Securities and Exchange Board of India in respect of listed entities apart from the banking regulator in respect of banks. Harmonising their policies in a dynamic setting is a daunting task for policy makers and adds to the complexities of the corporates or banks concerned to ensure compliance.

In regard to sectors such as banking in India where ownership of government is dominant, there are additional issues. Government, as an owner, is accountable to political institutions in terms of broader

socio-economic objectives and hence, its goals may not necessarily be compatible with purely economic incentives. Mixed ownership, with the government as a major shareholder, brings into sharper focus the possible divergent objectives of share-ownership in a corporate or a bank and issues relating to the rights of minority shareholders. The problem gets more complex if public ownership is exercised through separate legislation and not under the Company Law, normally applicable to other competing entities. The role of directors in such divergent organisational settings, therefore, needs a nuanced appreciation.

Let me end these general observations with an anecdote. When I was working in the World Bank in late 1970s, I joined the George Washington University for getting a taste of education in a foreign university. I took a course in management services. The Professor emphasised various aspects of organisational behaviour. I found that the best interest of the organisation that one serves was missing in the analysis. When I queried, he said: "it is your boss who interprets to you, what is good for the organisation". When I persisted, he added, "we deal with the corporate behaviour in the context of north American male in the U.S.A." I must confess that I continue to be old-fashioned. Any institution has, and in any case, should have a character, culture and interest that are worth pursuing even if they appear to be at variance from the sum of the interests of the individual, or the minority or the majority stakeholders. I will leave this thought of viewing corporate governance in broader terms extending beyond its immediate constituent stakeholders on the few occasions when a divergence in interests might arise. With this, let me move on to what we have been doing in RBI on this subject.

**Reserve Bank's approach**

The formal policy announcement in regard to corporate governance was first made by my distinguished predecessor, Dr. Bimal Jalan in the Mid-Term Review of the Monetary and Credit Policy on October 21, 2001. Pursuant to this announcement, a Consultative Group was constituted in November 2001 under the Chairmanship of Dr. A.S. Ganguly: basically, with a view to strengthen the internal supervisory role of the Boards. An Advisory Group on Corporate Governance under the chairmanship of Dr. R.H. Patil had earlier submitted its report in March 2001 which examined the issues relating to corporate governance in banks in India including the public sector banks and made recommendations to bring the governance standards in India on par with the best international standards. There were also some relevant observations by the Advisory Group on Banking Supervision under the chairmanship, Shri M.S. Verma which submitted its report in January 2003. Keeping all these recommendations in view and the cross-country experience, the Reserve Bank initiated several measures to strengthen the corporate governance in the Indian banking sector.

In June 2002, the report of the Ganguly Group was transmitted to all the banks for their consideration while simultaneously transmitting it to the Government of India for appropriate consideration. It may be noted here that there is a basic difference between the private sector banks and public sector banks as far as the Reserve Bank's role in governance matters relevant to banking is concerned. The current regulatory framework ensures, by and large, uniform treatment of private and public sector banks by the Reserve Bank in so far as prudential aspects are concerned. However, some of the governance aspects of public sector banks, though they have a bearing on prudential aspects, are exempt from applicability of the relevant provisions of the B.R. Act, as they are governed by the respective legislations under which various public sector banks were set up. In brief, therefore, the approach of RBI has been to ensure, to the extent possible, uniform treatment of the public sector and the private sector banks in regard to prudential regulations. In regard to governance aspects relevant to banking, the Reserve Bank prescribes its policy framework for the private sector banks while suggesting to the Government the same framework for adoption, as appropriate, consistent with the legal and policy imperatives.

As a follow-up of the Ganguly Committee report, in Mid-Term Review of the Monetary and Credit Policy in November 2003, the concept of 'fit and proper' criteria for directors of banks was formally enunciated, and it included the process of collecting information, exercising due diligence and constitution of a Nomination Committee of the board to scrutinise the declarations made by the bank directors. In this regard, it will be useful to refer to the RBI guidelines on ownership and governance in the private sector banks released recently.

It is heartening to note that based on the guidelines issued by RBI, all the banks in the private sector have carried out, through their nomination committees, the exercise of due diligence in respect of the directors on their Boards. In some cases, where the track record of the directors was not considered

satisfactory, the directors vacated their positions. In regard to some others, there is an on-going process to ensure 'fit and proper' status of the directors.

In this regard, it may be useful to distinguish the issue of the composition of the Board from the 'fit and proper' status of individual non-executive directors and chief executives. The first relates to collective expertise on the Board available to meet the competitive challenges before the bank to ensure commercial activity while maintaining soundness. The existing legal provisions in regard to banks stipulate specific areas of background that a director should be drawn from such as accountancy, banking, economics, finance, agriculture, etc., but do not specify the extent or degree of professionalism or expertise required in regard to that area. Hence, it is left to the good faith of the shareholders to elect directors from the various specified areas with qualifications and experience that is appropriate to the bank. In regard to public sector banks, such good faith is expected when directors are nominated by government.

However, when the issue of 'fit and proper' status of non-executive directors comes up, the norms only seek to ensure that the candidate should not have come to the adverse notice of the law and regulations or any professional body so that there is no objection from the RBI. In the case of non-executive directors not satisfying the 'fit and proper' criteria, there is a prescribed due process to be followed by the RBI to disqualify such directors, which includes opportunities to be heard. The position in regard to the CEOs of the private sector banks is on a different footing where the Reserve Bank is in a position to exercise its judgement on the suitability of the candidates proposed, in as much as the approval of the Reserve Bank is required for the appointment and the RBI may seek removal also. These provisions are broadly consistent with global best practices though there is scope for enhancing effective implementation.

There is no legal provision as of now for the Reserve Bank to insist on the 'fit and proper' status of the directors nominated by the government or elected by the shareholders to the Boards of the public sector banks. The appointment of the CEOs in the public sector banks, as well as their removal, is also a matter to be decided only by the Government of India. There is, however, active consultation with the Reserve Bank in regard to appointment of CEOs. Thus, by and large, there is *de facto* compliance with many governance requirements in public sector banks. .

## Way forward

As a step towards distancing the regulator from the functioning of the Boards, the Reserve Bank has withdrawn its nominee directors from almost all the private sector banks. Observers have been appointed as a transitional measures mostly in respect of those banks which are yet to fully comply with the Reserve Bank's guidelines of ownership of governance. It is hoped that the need for observers also will diminish as the quality of governance improves.

Second, legislative amendments have been proposed in regard to the public sector banks to remove the provisions for mandatory nomination of RBI officers on their boards and thus, to bring them on par with the private sector banks in this regard.

Third, the Government has been requested to keep in view the policy framework for governance in private sector banks while deciding on the appointments of the directors on the Boards' of public sector banks and constitution of various committees of the Board.

Fourth, the RBI, as far as possible, has recently been refraining from issuing circulars or instructions specifically addressed to the public sector banks. It is expected that all the existing instructions specifically applicable to the public sector banks will be reviewed by the Reserve Bank so that uniformity in regulatory framework between different categories of banks is formally established.

Fifth, several amendments to the Banking Regulation Act have been proposed which would enhance RBI's capacity to ensure sound governance specially relevant to the banks, consistent with global best practices.

In regard to urban co-operative banks (UCBs), there are unique problems which need to be addressed. Since all the governance aspects of urban co-operative banks fall entirely within the jurisdiction of the State Governments, while only prudential aspects are in the RBI's domain, it has been difficult to ensure effective co-ordination owing to the problems of dual control in the matters of governance which have a bearing on prudential regulation. Further, the market discipline in terms of shareholders' influence on governance does not exist in regard to urban co-operative banks since they do not depend on equity markets for their funds. Moreover, the governance structure in the UCBs

seems to be tilted in favour of the borrowers from the UCBs, thus, possibly undermining the interest of the depositors. Currently, to avoid problems of dual control, a mechanism of Memorandum of Understanding (MOU) with the State Governments, is being attempted. RBI has entered into such MoUs with Andhra Pradesh, Gujarat and Karnataka and is providing facilities for upgrading the skills of the members of the Board and the management of the UCBs, in these States.

The problem of dual control is even more acute in regard to the rural co-operative credit structure. However, these are being currently addressed by the Government of India in the light of the recommendations of the Vaidyanathan Committee.

The RRBs are yet another category of banks which are actually owned, in a pre-determined pattern, by the State, Centre and the sponsor banks. The sponsor banks are virtually managing the RRBs and the issues of governance of these institutions are yet to be addressed. Deposit taking NBFCs and, perhaps, NBFCs with systemic implications may also need to be considered for a careful review of their current governance practices in view of their unique role and expanding importance in our financial sector.

## Conclusion

Let me conclude with a reiteration that the Reserve Bank is continuously striving to ensure compliance with international standards and best practices of corporate governance in banks as relevant to India. RBI is also interacting closely with the Government and the SEBI in this regard. Increasing regulatory comfort in regard to standards of governance in banks gives greater confidence to shift from external regulation to internal systems of controls and risk-management. Each of the directors of the banks has a role in continually enhancing the standards of governance in banks through a combination of appropriate knowledge and values.

Thank you.