Journal of Advances and Scholarly Researches in Allied Education

Vol. IX, Issue No. XVII, Jan-2015, ISSN 2230-7540

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AN INTERNATIONALLY INDEXED PEER REVIEWED & REFEREED JOURNAL

www.ignited.in

Journal of Advances and Scholarly Researches in Allied Education
Vol. IX, Issue No. XVII, January-2015, ISSN 2230-7540

Corporate Governance in Indian Banking Sector

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Abstract – The fast development of Indian Banking Sector in the recent past has made a noteworthy contribution to India's socio economic progress and growth. The dawn of e-transaction services at the first place and competition fierce amongst service providers to increase market share has been a blessing in disguise for customers. All banks in the nation are interconnected through a widespread technology network. This dissertation will examine the corporate governance of banks. When banks effectively gather and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and motivates productivity growth. Therefore, weak governance of banks echoes throughout the economy with negative consequences for economic development. After reviewing the major governance principles for banks in general, this dissertation discusses two special characteristics of banks that make them special in practice: greater opaqueness than other industries and greater government regulation. These characteristics weaken many traditional governance mechanisms. Further, the dissertation reviews increasing evidence on which government policies improve the governance of banks and illustrates tentative policy lessons. In total, dissertation suggests that it is imperative to strengthen the capacity and incentives of private investors to exert governance over banks rather than relying greatly on government regulators.

Hypothesis

With reference to review of literature of corporate governance, and different types of banks, this dissertation develops the following hypotheses for study.

- ***Public sector banks are older and have better valuation than private sector banks. As Public sector banks' corporate governance practices significantly different than private sector banks.***
- ***Corporate governance practices have significantly influence the performance in the Indian domestic banks.***
- ***The recommendations of Birla Committee can deal with corporate governance practices in banks to a large extent.***
- ***Basel II committee recommendations can be applied efficiently to address severe issues of capital standards and capital measurement in a country like India.***
- ***India has undergone great policy implementation changes during the last decade due to the growing importance of banking sector in Indian economy.***
- ***The premise on which this dissertation seeks to proceed is that the system suffers from major loopholes that need immediate attention not only in order to increase the credibility and utility of this system but also to achieve the ethical needs.***
- ***Furthermore, the researcher proceeds on the premise that the need of each Bank is different from one another due its different demand-supply gap under its own financial circumstances.***

- ***Thus, this dissertation seeks to find answer to the aforementioned questions and prove the accuracy/validity of the abovementioned hypothesis.***

Research Questions

The paper will ask some fundamental questions on corporate governance in banking sector and will try to identify how it helps banks to certify transparency and growth. The questions are:

- ***How the elements of corporate governance help banking sector to create a situation, which can minimize fraud/malpractices in financial matter in banking sector?***

- ***Whether ownership pattern influences the effective governance and functioning of a bank?***

- ***What are suggestions to banking industry in regards attributes of corporate governance?***

Literature Review

We have relied on the book Corporate Governance Practices in India by Sanjay Bhayana, Regal Publications, New Delhi, 2007. This book covers expansively our field of research and we have relied considerably on its content. This book is a reference book for lawyers, students, individuals and bodies involved in the practice of corporate governance. The book covers the conceptual framework; identifies the self-regulatory developments, statutory developments in Corporate Governance and how they are used, and expound the generally applicable legal concepts. The other part of the book deals with the corporate governance practices, compliance of Birla Committee Recommendations, disclosures and transparency practices.

In addition, we have relied on Corporate Governance by Shadul S. Shroff, Wolters Kluwer (India) Pvt. Ltd., New Delhi, 2009. This book is a reference book for managers, bodies involved in providing services, students, and corporate heads. The book covers concepts like reforms in corporate governance, concepts, economic and financial reforms, corporate social responsibility, protection of stakeholders and their relevance to corporate governance.

Research Methodology

The paper is analytical, expressive and doctrinal in nature. Analysis of the Corporate Governance in Banking Sector will be carried out bearing in mind the different aspects of the economic condition of India in future. The scope of the research is limited to Primary and Secondary sources. The components of research may be divided as follows:

- ***A variety of books and journals have been referred to gain knowledge on the subject of corporate governance.***

- ***Online research was conducted to comprehend the various technicalities of the subject and latest developments in this field. Reference has been made to articles and news items, all which have been duly cited, available online especially for research on current governance environment.***

- ***Efforts have been made to incorporate latest facts and figures from information available on the Ministry of Finance and Reserve Bank of India.***

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INTRODUCTION

Banks are the backbone of the global economy, facilitating capital for novelty, infrastructure, and job creation and on the whole prosperity. They also have an important role in society, affecting not only expenses by individual consumers, but also the development of entire industries.

Though globalization of financial markets necessitates some essential international standards of corporate governance for financial institutions, it is also recognized that such identical international standards may result in diverse stages of systemic risk for different jurisdictions because of differences in business customs and practices and institutional and legal arrangement of national markets. Each nation will therefore require domestic regulations that prescribe detailed rules and procedures for the governance of financial institutions that deal with national differences in political economic and legal systems while assuming international standards and principles.

Banks are "special" as they not only recognize and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also control such funds through credit creation. The role of banks is vital to any financial system. They afford financing for commercial activities access to payment systems and a range of retail financial services for the economy at full. The vital role that banks occupy in the national economy is verified by the almost universal practice of states in regulating the banking industry and providing in many cases a government safety net to compensate depositors when banks fail. The huge number of stakeholders whose financial well-being depend on the strength of the banking system also depend on implementation of suitable regulatory practices and supervision. Certainly in a healthy banking system the regulators and supervisors themselves are stakeholders acting on behalf of the general public at large. As regulators banks do not act on behalf of shareholders or individual customers but on behalf of groups such as depositor policyholders or pension fund members who depend on the continued solvency of regulated institutions for their economic security but who are themselves not well placed to assess monetary soundness.

Banks unlike insurance companies are highly leveraged bodies and asset liability mismatches are an intrinsic feature of their business. As a result, they surface a wide range of risks in their day-to-day transactions. Any mismanagement of risks by these bodies can have very serious and drastic consequences on a stand-alone foundation which may pose a grave danger for financial stability. It further strengthens our idea that efficient risk management systems are vital for financial institutions and emphasizes the need for these to be managed with great accountability and maturity. Good corporate governance, therefore, is most important to achieve this objective.

1. CORPORATE GOVERNANCE: DEFINITIONS

The word 'governance' has been derived from the word '*gubernare'*, which means "to rule or steer".[1] Initially this term meant to be a normative frame for exercise of power and acceptance of answerability used in the running of kingdoms, regions and small towns. But, with the passage of time it has found significant implication in the corporate world. All this is chiefly due to growing number and size of the enterprises, the widening basis of the shareholders, increasing linkages with the physical environment, and overall impact on the society's wellbeing as we require a appropriate administrative arrangement to regulate so many intricate things.

The interpretation of World Bank definition on corporate governance seems more proper as it analyses from two different viewpoints. From the company's perspective, the pressure is put on the relations between the various stakeholders such as owners, management, employees, customers, suppliers, investors and communities. From another outlook in defining corporate governance is reliable path where the corporate governance organisations can be established. So, a "nation's system of corporate governance can be seen as an institutional matrix that structures the relations among owners, boards, and top managers, and determines the goals pursued by the corporation"[2].

"Corporate Governance is a system by which companies are governed and controlled.[3]" – Cadbury Committee Report

"Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company[4]" – Narayana Murthy Committee Report.

Shri Narayana Murthy in his Report believed that: *"Corporate governance is beyond the realm of law. It stems from the culture and mind-set of the management and cannot be regulated by legislation alone. Corporate governance means the conducting the affairs of a company in such a way that there is fairness to all stakeholders and its actions benefits the greatest number of stakeholders. It is all about openness, integrity and accountability.[5]"* He also stated that: *"Corporate governance is the key element in improving the economic efficiency of a company and makes the Board accountable to shareholders. The failure to implement corporate governance can have a heavy cost beyond regulatory problems. Companies that do not employ good governance can pay a significant risk premium when competing for scarce capital in the public markets. The credibility offered by corporate governance also helps to maintain the confidence of both the foreign and domestic investors,*

[1] www.ccsenet.org/journal/index.php/ijbm/article/download/6228/4922

[2] www.afic.am/CG/CGProblemsInTransitionEconomies.pdf

[3] Shardul S. Shroff, "Corporate Governance: Features and Problems of Law Reforms" *Corporate Governace*, Wolters Kluwer (India) Pvt. Ltd., New Delhi, 2009 p 18.

[4] *Ibid*

[5] *Ibid 1*

which helps in attracting more patient long term capital and also will reduce the cost of capital"[6].

Corporate governance is a *sine qua non* for corporate success.[7] Shekar Datta, the then President, Confederation of Indian Industry (CII) stated in the preamble to the report of the Rahul Bajaj Committee on Corporate Governance in India, (Cn Report, 1998) that:

"Corporate Governance is a phrase which implies transparency of management systems in business and industry, be it private sector, public sector or the financial institutions. Just as industry seeks transparency in government policies and procedures, so also, the debate on corporate governance seeks transparency in the corporate sector."

Corporate governance, thus, symbolise a concept of total transparency, integrity and accountability of the management so as to suit the best awareness of all stakeholders coupled with maximization of shareholder value. The commitment to ethical business conduct is the comer stone of good corporate governance.

The OECD'S (1999) novel definition is: "*Corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance*"[8].

As per Economist and Noble Laureate Milton Friedman, "*Corporate Governance is to conduct the business in accordance with owners or shareholders' desires, while conforming to the basic rules of the society embodied in law and local customs*".[9] In capsule, it can be said that corporate governance means doing everything better to improve relationships between companies and their shareholders, to improve quality of outside directors, to encourage people to think long-term and to ensure that information needs of all stakeholders are met. The discussion on governance has been dated back more than two decades in different economies. Travelling through the pre-1992 American discussions on disassociation of power and money (emanating from the Watergate Scandal), post-1992 Cadbury Report on governance codes and OECD principles (1998 & 1999), and corporate governance has not yet settled at any universally accepted definition.

This word "Corporate Governance" which was rarely encountered before the 1990s has now become an omnipresent term from two decades. In today's set-up this term has become one of the most decisive and important concept in the administration of companies. The root of corporate governance dates back to Adam Smith but its popularity is of recent origin. The concept of corporate governance can be understood as "the system through which shareholders are assured that their interest will be taken care of by management". In a much wider way, corporate governance was defined as "the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment"[10].

The literature on corporate governance in its wide implication covers a variety of aspects, such as protection of shareholder's rights, improving shareholders' value, board matters etc.

It may be called as a deposit of processes, customs, policies, laws and institutions affecting the way in which a corporate body is directed, managed or controlled. Corporate governance also includes the relationships among the many players involved (the stakeholders) and the goals for which the corporation is governed. The main actors are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at full.

It is a multi-dimensional topic. An important theme of corporate governance deals with issues of answerability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic effectiveness, through which the corporate governance system should aspire to optimize economic results, with a strong stress on shareholders welfare. There are some more features to the corporate governance subject, such as the stakeholder view, which calls for more attention and

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[6] *Ibid 2*

[7] http://books.google.co.in/books?id=SXKS6KgCVTkC&pg=PA39&lpg=PA39&dq=Corporate+governance+is+a+sine+qua+non+for+corporate+success&source=bl&ots=Yc2hRQrytd&sig=owFb6wGPnFf9K7bAxWvknBgAb2k&hl=en&ei=ACR4TpDTLs3yrQeuq4SICw&sa=X&oi=book_result&ct=result&resnum=1&ved=0CBoQ6AEwAA#v=onepage&q=Corporate%20governance%20is%20a%20sine%20qua%20non%20for%20corporate%20success&f=false

[8] *www.lfhe.ac.uk/**governance**/ab**outgovernance**/whatis**governance**.html*

[9] http://books.google.co.in/books?id=pBSmQdmX8LsC&pg=PA347&lpg=PA347&dq=Corporate+Governance+is+to+conduct+the+business+in+accordance+with+owners+or+shareholders%E2%80%99+desires,+while+conforming+to+the+basic+rules+of+the+society+embodied+in+law+and+local+customs&source=bl&ots=F2bu1iRVgS&sig=BIwFzgNpJkaOy82x6feMKBiHaLk&hl=en&ei=QSV4Tu3kFcbTrQePwpG1Cw&sa=X&oi=book_result&ct=result&resnum=2&ved=0CCAQ6AEwAQ#v=onepage&q&f=false

[10] unpan1.un.org/intradoc/groups/public/documents/.../UNPAN015471.pdf

accountability to players other than the shareholders such as the employees or the environment.

Recently there has been considerable interest in the corporate governance practices of modern corporations, particularly since the high-profile collapses of a number of large U.S. firms such as Enron Corporation[11] and WorldCom[12].

Board members and those with a responsibility for corporate governance are more and more using the services of external providers to operate anti-corruption auditing, due diligence and training.

The concept has been drawing public attention from quiet a long time in India. The topic is no longer confined to the halls of academia and is more and more finding acceptance for its relevance and fundamental importance in the industry and capital markets. Progressive firms in India have voluntarily put in place systems of good corporate governance. Internationally also this concept has been accepted for a long time and the financial crisis in emerging markets has led to renewed discussions and inevitably focussed them on the lack of corporate as well as governmental oversight.

Strong corporate governance is crucial to resilient and vibrant capital markets and is a real instrument of investor protection. Internationally, a growing school of influential thinkers advocate that corporate governance policies should be more by self-discipline and market forces, rather than by legislation and regulation. This, of course, is exceptionable and deserves full support. Although India has been fortunate in not having to go through the pains of massive corporate failures such as Enron and WorldCom, it has not been interested wanting in its longing to further improve corporate governance standards.

In India the subject-matter of corporate governance has come up mainly in the wake of economic liberalization and deregulation of commerce industry and business and the demand for a new corporate culture and stricter compliance with the law of the land. In the context of the unique situation in India where the financial institutions hold substantial stakes in companies the accountability of the directors including non-executives and nominees has come into quick focus.

Traditional neo-classical theory of the firm makes no distinction between the firm's managers, creditors and owners. The firm is treated as a single identical entity that acts to maximize total value by maximizing the discounted value of expected future cash flows. Finance is considered to be just another important factor of production. If all marketable factors of production are valued in competitive markets the allocative efficiency of the economy would be assured by the maximization of the residual after payments to those marketable factors. If the claimant of residual is comfortable with the stockholders who do not gain any benefits other than the residual, then they would be unanimously interested in maximizing the stock value of enterprises as reflected in the discounted sum of expected future flow of residual. Thus, the corporate governance structure in the neo-classical model relies on the model of stockholder sovereignty.

Therefore, increasing shareholder value is considered important as this narrow focus on performance can lead to a number of malpractices, eventually affecting investors and other creditors. The new model for corporate governance therefore focuses on laying down minimum standards and defining the role of the various players involved in corporate governance. Accountability, it is emphasized, is not merely to the investors but also to the creditors, employees, consumers and the community as a whole.

2. HISTORY OF CORPORATE GOVERNANCE IN INDIA

The development and reform of corporate governance norms during the last decade has drawn inspiration from the developments that occurred in other parts of the world; particularly the Sarbanes-Oxley Act in the U.S. and the Cadbury Committee Report in the U.K.

The genesis of corporate governance lies in the business scams and corporate failures - while the Enron debacle or the more recent tribulations of the Lehman Brothers have been offshore incidences, the shenanigans of Harshad Mehta and the latest Satyam Saga reflect the susceptibility of India in the matter of corporate governance.

The era post liberalization witnessed a spate of activities culminating a need for better corporate governance in the country. The evolution of the corporate governance guidelines in the global context and from the perspective of progress made in India is given below in the points[13]:

[11] The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was attributed as the biggest audit failure.

[12] Telecommunications giant WorldCom came under intense scrutiny after yet another instance of some serious "book cooking". WorldCom recorded operating expenses as investments. In total $3.8 billion worth of normal operating expenses - which should all be recorded as expenses for the fiscal year in which they were incurred - were treated as investments and were recorded over a number of years.

[13] Dr. Bandi Ram Prasad "Recent Developments in Governance Practice in Indian Corporate"

- Cadbury Report, United Kingdom 1995 -The objective of the Cadbury committee was to investigate how large public companies should adopt corporate governance guidelines with a focus on the procedures of financial report production and the role of the accounting profession. Issues included the role of the board of directors, standards of financial reporting, accountability of the auditors and directors pay.

- Greenbury Report, United Kingdom, 1995- The report dealt with the remuneration of executives and non-executives board members and recommended the setting up of a Remuneration committee in each public company to determine remuneration packages for the board members. It also provided suggestions on the disclosure of remuneration and the setting up of remuneration policy and service contracts and compensation.

- Hampel Report, United Kingdom, 1998- Four major issues were discussed with practical guidelines offered; (a) the role of directors (b) directors compensation (c) the role of shareholders (d) accountability and audit.

- CII Voluntary Code of Corporate Governance, 1998 -The first of the voluntarily evolved codes in India.

- Kumara Mangalam Birla Committee, India, 1999- The mandatory recommendations of the Kummar Mangalam committee include the constitution of Audit Committee and Remuneration Committee in all listed companies, appointment of one or more independent directors in them, recognition of the leadership role of the Chairman of a company enforcement of Accounting Standards., the obligation to make more disclosures in annual, financial reports, effective use of the power and influence of institutional shareholders, and so on. The Commiittee also recommended a few provisions, which are non-mandatory.

- *Sarbanes-Oxley Act, 2002-* A major initiative of corporate compliance, the *Sarbanes-Oxley Act, 2002,* is also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a US federal law that has main features such as establishment of the Public Company Accounting Oversight Board (PCAOB), auditors independence, corporate governance, internal control assessment, and enhanced financial disclosure.

The first initiative towards the extant corporate governance policy was brought by the Confederation of Indian Industries ("CII") through its CII Code for Desirable Corporate Governance under the chairmanship of Rahul Bajaj. This paved the way for the formation of the Kumaramangalam Birla Committee by the Securities Exchange Board of India ("SEBI") which led to the incorporation of clause 49 in the Listing Agreement. Subsequent recommendations of the *Malegam Committee Report, 2002,* amended the *SEBI (Disclosure and Investor Protection) Guidelines, 2000.* The Naresh Chandra Committee Reports of 2002 and 2003 resulted in further amendments to clause 49. In a nutshell the evolution of corporate governance in India comprised:

- Kumarmangalam Birla Committee Report (1999) recommendations led inter alia, to the incorporation of Clause 49 into the Listing Agreement.

- Malegam Committee Report (2002) recommendations led to amendments in the *SEBI (Disclosure and Investor Protection), Guidelines, 2000.*

- Naresh Chandra Committee Report I (2002) recommendations led to the *Companies (Amendment) Bill, 2003.*

- Narayana Murthy Committee Report (2003) recommendations led to amendments to Clause 49.

- Second Narayana Murthy Committee Report. (2003) proposed amendments to Clause 49.

- J.J. Irani Committee on Companies Law (2005) recommended shift towards a regime of self-governance and disclosure as opposed to external control by the regulator.

The set of codes developed by the Indian policy makers for corporate governance encompass:

- Companies Act, 1956

- Securities Contract Regulation Act, 1956

- Listing Agreement, Clause 49

- SEBI Regulations

- Disclosure & Investor Protection Guidelines, 2000

- SEBI(Substantial Acquisition of Shares and Takeovers) Regulations, 1997
- SEBI (Prohibition of Insider Trading Regulations), 1992

The expansion of the number of companies in India from about 30,000 in 1956 to nearly 7 lakhs, the liberalization of the Indian economy, increase in the number of options and avenues for international business, trade and capital flows had imposed a requirement not only for harnessing entrepreneurial and economic resources efficiently but also to be competitive in attracting investment for growth. Though the Ministry of Company Affairs had earlier introduced the Companies (Amendment) Bill, 2003, a large number of changes were found to be necessary in the Bill owing to these developments and necessitating modernization of the regulatory structure for the corporate sector in a comprehensive manner leading to the Ministry of Corporate Affairs taking up a comprehensive revision of the *Companies Act,* 1956 in 2004. The review and redrafting of the *Companies Act,* 1956 has been taken up by the Ministry of Corporate Affairs on the basis of a detailed consultative process. The Government also constituted an Expert Committee on Company Law under the Chairmanship of Dr. J.J. Irani to advice on the new Companies Bill. The Committee submitted its report to the Government on 31st May 2005. Detailed consultations were also taken up with various Ministries, Departments and Government Regulators. The Bill has been thereafter drafted in consultation with the Legislative Department of the Central Government. The new *Companies Code, 2012* aims to enable the corporate sector in India to operate in a regulatory environment of best international practices which will foster entrepreneurship, investment and growth.

It is noteworthy to mention that India has been ranked high on several features of corporate governance such as shareholder rights, creditor rights, disclosure requirements, liability standards and quality regulations. However, the law reforms which brought about the above features are fraught with limitations on the aspects such as enforcement, corruption, red tape etc. While the Indian companies have won global accolades for the corporate governance on one hand, the securities market regulator has shown caused some companies, including the public sector, to tone up the governance parameters on the other.

The beginning seeds of modern corporate governance were probably sown by the Watergate scandal in the USA. Consequent investigations by US regulatory and legislative institutions highlighted control failures that had allowed several foremost corporations to make illegal political contributions and bribe government officials. At the same time as these developments in the US stimulated debate in the UK, a wave of scandals and collapses in that country in the late 1980s and early 1990s led shareholders and banks to be anxious about their investments. Several companies in UK which saw explosive growth in earnings in the '80s ended the decade in a memorably catastrophic way. Importantly, such spectacular corporate failures arose primarily out of poorly managed business practices.

It is useful in this context to recall the circumstances in which the Committee on financial aspects of corporate governance called the Cadbury Committee was set up and also the other factors which led to a rise in the interest in corporate governance in UK. The Committee was set up by the Financial Reporting Council, London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. Its sponsors were concerned at the apparent low level of confidence both in financial reporting and in the aptitude of auditors to provide the safeguards which the users of company reports sought and expected. These concerns about the working of the corporate system were finely tuned by some unexpected failures of major companies and by criticisms of the lack of effective board accountability for such matters as directors pay which had risen to excessive levels not related to implementation. The cause of their anxiety was not so much that these companies had failed as that their reports and accounts just prior to their failure, appeared to give no forewarning of the true state of their financial affairs. Its sponsors feared that if no action was taken to improve standards of financial reporting this could affect London's reputation as a financial centre and the reputation of British accounting firms. Later director's pay became such a live political issue that a study group on director's remuneration was formed under Sir Richard Cadbury to deal with directors' pay.[14]

The Cadbury Committee addresses a number of explicit issues. Substantial attention has been paid to the role of Board of Directors. The report touches on such issues as the composition of the board, separation of the post of the chairman and the chief executive, the role of the outside non-executive directors etc.[15] while recognizing the importance of the Boards in driving their companies forward, the report stresses the need for effective accountability. One important section in the Cadbury report relates to financial reporting and financial controls. As the report says "the life blood of markets is information and barriers to the flow of relevant information represent imperfections in the market".[16] The report also adds that "the cardinal principle of financial reporting is that the view presented should be true and fair. Further principles are that boards should aim for the highest level of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to

[14] www.iba.org.in/events/1.N.1Balasubramanian.ppt
[15] *Ibid*
[16] rbidocs.rbi.org.in/rdocs/Speeches/PDFs/2506.pdf

ensure the integrity and consistency of their reports and they should meet the spirit as well as the letter of reporting standards”[17]. Transparency through greater flow of information thus becomes necessary.

As the Cadbury Committee Report has repeatedly stressed, openness, integrity and accountability must be the key elements of corporate governance. In ensuring effective accountability besides the Board of Directors, external auditors and audit committees, the capital markets, institutional investors and banks also have a role to play.[18]

Blue Ribbon Committee was formed under the direction of the United States Securities and Exchange Commission. It was constituted to develop recommendations to enable “audit committees to function as the ultimate guardian of investors’ interests and corporate accountability”. The committee recommended enclosing ‘Statement of Disclosure by Audit Committee to the shareowners’, and certificate of Statutory Auditors regarding Independence’. *Euroshareholders Corporate Governance Guidelines 2000* are more specific and detailed. It has given ten recommendations on disclosure of information in the annual reports. It states that “a company should aim at maximizing shareholders value in the long term. Companies should clearly state (in writing) their financial objectives as well as their strategy, and should include these important ones in the Annual Report”. Some of the important recommendations are:

- Shareholder’s approval is required for major decisions which can affect the standing of shareholders within the company. This approval is also necessary for important decisions which may deeply affect the risk profile, organization, size and the nature of the business. These decisions can also be approved by the AGM.

- There should be no bias involved in electing the auditors. The entire process of election should be very transparent. Auditors should be independent and elected by the general meeting. Shareholders should be provided price sensitive information through regular as well as electronic means.

The Report generated a lot of interest in India. The issue of corporate governance was studied in depth and dealt with by the Confederation of Indian Industries (CII), Associated Chamber of Commerce and Industry (ASSOCHAM) and Securities and Exchange Board of India (SEBI). These studies reinforced the Cadbury Report’s focus on the crucial role of the Board and the need for it to observe a Code of Best Practices. Co-operative banks as corporate entities possess certain unique characteristics. Paradoxical as it may sound, evolution of co-operatives in India as peoples’ organisations rather than business enterprises adopting professional managerial systems has hindered growth of professionalism in co-operatives and proved to be a neglected area in their evolution.

In spite of the Companies Act, 1956, outlining a structure for Corporate Governance, defining the board’s authority and responsibility, and creating an arrangement of checks and balances with penalty for breaking the law, a need was felt for a comprehensive code of corporate governance. In India, the confederation of Indian Industry (CII) tried to fill in this gap by outlining a code of corporate governance in April 1988 followed by the Ramakrishna Commission on PSU corporate Governance and the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance in December 1999. CII’s code Desirable Corporate Governance in India emphasized the frequency of board meetings, removal of Financial Institutions (FI) from the management where shareholding is less than 10%, withdrawal of FI’s nominees from the board of companies which are not defaulting in loan payment, transparency in credit ratings of financial instruments, removal of restrictions on the takeover of companies and debarring companies from accepting further deposits (*CII Report, 2003)*.[19]

The Ramakrishna Commission on Public Sector Undertakings (PSU’s) corporate governance emphasized autonomy in professionalizing the board, providing incentives for the top management, accountability, autonomy in price fixation, strengthening investors interface, power to dispose of assets, providing for elected directors, setting up a pre-investigation board, freedom in investing within certain limits, and power to enter a joint venture *(Ramakrishna Commission Report, 1999)*.[20] Security and Exchange Board of India (SEBI’s) *Kumar Mangalam Birla Report* has been enshrined in clause 49 of the listing agreement of every Indian stock exchange. A beginning has been made in India for mandatory observance of corporate governance practices, through clause 49 of the Listing Agreement of the Stock Exchanges. The recommendations of the committee are mandatory. The mandatory recommendations of the Report are:[21]

- Half the directors on the board should be independent if the chairman is executive and one third if the chairman is non-executive.

- The audit committee will investigate reasons for financial transparency. The committee

[17] *Ibid*
[18] *Supra note 16*

[19] edissertations.nottingham.ac.uk/1888/1/08MAlixpg3.pdf.pd
[20] Supra note 19
[21] Supra note 19

should have minimum three non-executive directors. The majority of these directors should be independent. At least one director should have some knowledge in the field of accounting and finance. The audit committee should meet at least three times a year.

- The board of companies should meet at least four times a year.
- A remuneration committee should be set up to determine the remuneration packages, including performance-linked incentives, stock options etc, of the executive directors.
- A committee should be formed to study investor's complaints.
- The chairman of all the committees should be present at the AGM to answer the shareholders' queries.
- The directors cannot be members of more than 10 committees across companies and cannot chair more than five committees.
- The annual report should have a section on corporate governance reporting the status of compliance.
- The non-executive chairman should be provided with an office and the expenses should be reimbursed to make him effective.
- The annual report should have the detailed resumes of newly appointed directors.
- The non-mandatory recommendations of the committee are:
- "Non-executive Chairman to maintain Chairman's Office at company's expense.
- Board to set-up a Remuneration Committee to formulate company's remuneration policy on specific remuneration package for Executive Directors.
- Half-yearly declaration of financial performance including summary of significant events in last six months to be sent to shareholders.
- Company may move towards regime of unqualified financial statements.
- Company may train Board Members in the Business Model of the Company as well as risk profile of the business parameters of the company, the responsibilities as Director and the best way to discharge them.
- The evaluation of performance of non-executive Directors by other members of the Board and to decide to continue or otherwise of the Directorship of the non-executive Directors.
- The Company to establish the Whistle Blower Policy for reporting management concerns about unethical behaviours, actual or suspected fraud, etc".

Similar to other studies, the research also found that after a definite level of block holdings by directors the company value enhances. But it did not find any substantial proof that institutional investors, normally mutual funds, are active in corporate governance. The outcome advocates that lending institutions start supervising the corporation efficiently only after the equity holding cross a considerable value and this supervision is reinforced by the level of liability of these corporations. The study provides substantial proof that company value is enhanced by foreign equity ownership. In general, the analysis supports the view emerging from developed country studies that the Identity of large shareholders matters in corporate governance.[22]

The companies with good corporate governance measures are easily able to borrow money from financial institutions as compared to companies with poor corporate governance measures. Moreover, there is evidence that mutual funds have invested money in companies with a good corporate governance track record as compared to companies with a poor CG track record. By making use of a simultaneous equation approach, this study wraps up by saying that this positive relationship is a result of the "mutual funds (development financial institutions) investing (lent money) in companies with good governance records" and also because "their investments have helped to enhance the financial performance of such companies"[23].

Irrespective of the business goal considered, effective governance guarantees that the administration (managers and the board) are responsible for achieving it. The job of successful corporate governance is of immense significance to society as a whole:[24]

In the first place it promotes efficient use of scarce resources both within the organization and the larger economy. Secondly, it makes the resources flow to those sectors or entities where there are efficient

[22] Supra note 19
[23] *Supra note 19*
[24] Supra note 19

production of goods and services and the return is adequate enough to satisfy the demands of stakeholders. Thirdly, it provides a broad mechanism for choosing the best managers to administer the scarce resources. Fourthly, it helps the managers to constantly focus on enhancing the company performance, ensuring that they are sacked when they don't succeed in doing so. Fifthly, it puts pressure on the corporation to abide by the law as well as achieve what the society expects from it. And last but not least, it assists the supervisors in regulating the entire economic sector without partiality and nepotism.

3. CHANGES SINCE LIBERALIZATION IN BANKING SECTOR

We live in a world full of uncertainties. In today's liberalized environment, savers/investors/borrowers and institutions are dispersed all over the world crossing the geographical boundaries. The number and frequency of bank failures/ mergers and acquisitions in the world have increased rapidly in recent years both in the controlled as also liberalized economies. Increasing globalization with blurring of distinction between different segments of the financial intermediaries has rendered it necessary to safeguard the health of the financial system with a view to enhancing excellence and maintaining financial stability. Recent experiences in East Asia and elsewhere have brought to the fore the criticality of financial system's stability for ensuring sustainability of openness in invigorating economic growth.

The financial sector reforms in 1991-92 to second phase initiatives in 1998, a lot of ground has been covered by putting in place a financial system which can meet the requirements of a more competitive and open policy. The Indian banking system has been responding proactively to the challenges in its operating environment ever since. There has been significant improvement in the performance of the commercial banking system, measured in terms of both operating as well as net profits. In view of growing concerns about financial stability, prudential norms have been gradually tightened on par with international best practices. Banks have also been accorded greater operational flexibility in conducting their business. As part of the reform process, banks have adopted several initiatives to strengthen their business practices. These include, among others, greater product sophistication, increased customer orientation, improved risk management, particularly in the credit risk management techniques, updated MIS, greater focus on electronic banking channels and diversification to newer business areas.

The last decade witnessed the maturity of India's financial markets. Since 1991, every governments of India took major steps in reforming the financial sector of the country. The RBI has given licences to new private sector banks as part of the liberalisation process. The RBI has also been granting licences to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance. The prudential measures aim at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility. Financial sector reforms have virtually altered the organizational forms, ownership patterns and domain of operations of bank and financial institutions. The objectives of policy measures under the financial sector reforms continue to remain strengthening of the sector through strict operational, prudential and accounting norms set to converge gradually to international standards, improvement in the credit delivery system and gradual shift to uniform regulatory framework for different types of institutions.

Thus, exposure and disclosure norms were accordingly stiffened. Comprehensive guidelines on investments, risk management, asset classification and provisioning requirements have been assigned to the banks. Banks have also been motivated to prepare themselves for adopting best international practices for assigning capital market risk. So to adhere to the opinion of mitigating the potential conflict of interest regarding issues of ownership, risk-based supervision, consolidated accounting and supervision, the regulatory oversight has been redefined. Policy attention was also drawn to issues in the management of non-performing assets (NPAs) and related supervisory initiatives including setting up of Asset Reconstruction Companies.[25] New avenues of banking activity in insurance were created. The supervisory strategy consists of four-pronged approach i.e.[26] (i) restructuring the system of inspection, (ii) setting up of off-site surveillance, (iii) enhancing the role of external auditors, and (iv) strengthening corporate governance. In achieving the international standards, conciliation has occurred in certain cases in view of unique and economy specific circumstances. While the reforms have been gradual, in certain cases these have been intensified beyond the 'best-practices' also.

4. ROLE OF GOVERNMENT IN GOVERNANCE OF BANKS

There are three reasons for degree of government oversight in this sector.

- It is understood that the depositors, particularly retail depositors, cannot

[25] "KarunSagar "Promoting Excellence in Banking Industry: Regulatory/Supervisory Perspective" in Ramesh K. Arora and Tanjul Saxena edn., *Corporate Governance: Issues and Perspective,* Mangaldeep Publicatios, New Delhi 2004 p. 186
[26] *Ibid*

effectively protect themselves as they do not have adequate information, nor are they in a position to coordinate with each other.

- Bank assets are unusually opaque, and lack transparency as well as liquidity.

- It is believed that that there could be a contamination effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy.

Government have to play a key role in corporate governance by defining the legal environment and at times by directly influencing managerial decisions. As stressed above, the efficiency of the bankruptcy system and the degree to which managers preserve control through the bankruptcy process help to determine whether the peril of bankruptcy influences managerial decisions. Likewise, the ability to write and then perform contracts, to oblige management to provide exact and comprehensive information before shareholders vote on important issues, to perform the obligations of the boards of directors, to denote and have managerial incentive contracts performed, and to have confidence in the full range of contractual arrangements that define the firm in modern corporations all determine the extent to which equity and bond holders can exert corporate governance.[27] Moreover, political economy forces that produce the laws, enforcement mechanisms, bankruptcy processes, and the ability of powerful managers to influence legislation will deeply shape corporate governance. Beyond defining the rules of the game, the government may directly influence corporate governance. On the one hand, the government owns the firm, so that the government is charged with supervising managerial decisions and limiting the ability of managers to maximize private interests at the cost of society. At a low level, governments also regulate corporations.

In particular, governments regulate the activities and asset allocations of corporations and may even insure corporate liabilities in favoured industries, even in economies that traditionally drift to disprove such support. In assumption, governments regulate to capitalize on social welfare, limit adverse externalities and exploit positive ones, deal with monopoly power, and directly bar managers from undertaking socially adverse actions one can argue that governments will tend to use regulations instead of the threat of legal sanctions when the legal system does not effectively deter managers from taking socially costly actions.

The definitive way in which bureaucrats intervene with the operation of a bank is through outright government ownership. Although this ownership is decreasing in recent decades, by the late 1990s, show that in emerging markets, about 40% of the assets in the banking system are in state owned banks.[28] This figure was much higher in some of the more populous countries like China, India, and Indonesia.

When the government is both the owner and regulator, there is a conflict of interest in its two roles, and any hope of independent supervision would appear unrealistic. Indeed, in some countries, such as China, the government executives who run the state banks outrank the heads of any oversight agencies. Usually, bureaucrats might be expected to be less motivated by market forces than their private sector counterparts, and instead will respond more to political influence. The government ownership of banks is negatively associated with banking sector development and positively associated with measures of bank inefficiency interest rate spreads and overhead costs. There are some links between government ownership and crises. There is no evidence, even in weak institutional settings, that government-owned banks overcome market failures and channel credit to productive ends.

The conflict of interest for the government as owner and regulator of banks likely becomes overwhelming when government owns a substantial stake in industry as well. Thus if one set of bureaucrats, those overseeing a given firm, do their job poorly, they can try to hide the problems with a bank loan from a fellow bureaucrat. This is a similar tendency that would operate between related parties controlling a bank and a firm, but at least then the markets and the government exist to provide some oversight, whereas with state banks, the government has been removed as an effective monitor. Lastly, although private sector participants, such as large creditors, have an incentive to monitor private banks, with state owned banks there is no doubt that the government is providing a guarantee. Thus, private sector entities will have no incentive to monitor state banks. In sum, neither the owners, the markets nor, the supervisors are likely to be providing effective corporate governance when banks are state owned. During the East Asian crisis, the performance of state banks deteriorated more markedly than privately owned banks, and this effect was greater the larger the overall presence of state banks.[29]

One potential check on government-run banks is competition in the output market, but here again these forces are muted. In particular, the banks that are most likely to be willing to compete against the state foreign banks usually are kept out of the market[30]. This lack of competition explains their aforementioned finding of higher interest costs and higher overheads. The absence of standard corporate governance

[27] *citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.19.254*

[28] *Supra 24*

[29] *Supra note 16*

[30] *Supra note 16*

mechanisms does not necessarily mean that all state banks are bad. Rather, the results indicate that those countries with a greater share of state ownership in banking experience poor outcomes. Equally, considerations of corporate governance in emerging market banking without taking state ownership into account likely misses the major actor in the play.

The problem with using state ownership and regulation of corporate activities to resolve the corporate governance problem is that this places control rights in the hands of government bureaucrats that almost certainly do not have the same incentives as a private owner. Thus, these government bureaucrats are unlikely to induce managers to maximize firm value. Sometimes, politicians use state enterprises for personal gain either by placing cronies in position of corporate power, catering to special interest groups, or supporting politically influential unions that help politicians to retain power. Indeed, the evidence suggests that public enterprises are extremely inefficient producers and they frequently disregard social objectives, as evidenced by the finding that state enterprises are worse polluters than private firms.

4.1. Challenges Ahead

Thoughts which have a key bearing on the ability of Indian banks to remain competitive and enhance soundness are as follows:

Cost management: It is an explanation to sustainability of bank profits and their long-term viability as well.

Recovery management: This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in containment of non-performing loans (NPL) considering the overhang issues and overall difficult environment.[31] The process would, though, need to be pursued in sincerely, while continuing with the changes in legal, institutional and procedural aspects to bring about a favourable environment for banks' transactions. Obviously, cost and recovery management supported by enabling legal framework has the key to future competitiveness of Indian banks.

Technological intensity of banking: This is the single area where perhaps India needs to do significant 'catching up', in spite of the rapid strides made over the last few years. It is wise for Indian banks to exploit this globally state of art expertise domestically accessible to their maximum advantage.

Risk management: Banking in modern countries is all about risk management. The successful negotiation and implementation of Basel II recommendations is likely to lead to closer focus on risk measurement and risk management at the institutional level. Fortunately, Basel II has, through their various publications, provided useful guidelines on managing the several aspects of risk. The institution of sound risk management practices would be an important support for remaining ahead of the fast increasing competition. Banks can, on their part, formulate 'early warning indicators' suited to their own requirements, business profile and risk appetite in order to better monitor and manage risks.[32]

Governance: The irregularities concerning accounting firms in the US have fully demonstrated the importance of good corporate governance practices. The quality of corporate governance in the banks becomes crucial as competition intensifies, banks try hard to retain their client base, and regulators move out of controls and micro-regulation. The objective should be to continuously strive for excellence. The RBI has, on its part, made brilliant efforts to improve governance practices in banks, stimulating upon international best practices. It is remarkable to know that corporate governance presently finds explicit mention in the annual reports of several banks. The enhanced corporate governance practice would also offer an opportunity to accord greater freedom to banks' boards and move away from micro regulation to macro management.

5. NEED FOR CORPORATE GOVERNANCE IN BANKS

From the banking industry viewpoint, the attributes of corporate governance provide guidelines to the directors and the top level managers to govern the business of banks.

As we are marching forward towards as a global leader, there are many economic issues coming up in the process for developing and transitional economies. These can be rightly recognised as structural changes in market institutions. It brought about the very awareness among investors, bankers and public at large. Such economy faced a retarded growth in spite of having economic reform like privatization, liberalization and lifting licensing raj. In spite of this flow of money in such economy, the growth could not take its stand due to unbalanced approach. The holder of 'para-state' institutions such as privatization funds remain in the hands of largest shareholders of companies. As a result, "the *de facto* power remains loaded in the hands of few individuals considered as internal owners, while the external owners do not have enough power to control the

[31] http://www.drnarendrajadhav.info/drnjadhav_web_files/speeches/INDIAN%20BANKING%20AND%20FINANCE_GUV%20SPEECH_FINAL1.pdf

[32] *Supra note 18*

companies and thereby can't ensure themselves to get appropriate returns"[33].

One more important factor in banking industry in developing economies is that banks are mostly owned by government. In such condition, banks are mostly guided by government bodies and many laws based on stereotype procedures. The accountability idea is less apparent as the concept of government job discourages the spirit of competition. The need for corporate governance in developing, emerging and transitional economies not only arises from resolving problems of ownership and control, but also from ensuring transparency in achieving the desired goal of corporate governance.[34] In many cases, developing and emerging economies are beset with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing.[35]

Moreover, the significance of corporate governance in banking sector considers very much due to very nature of banking transactions. Banking is the crucial factor effecting economic development of an economy. It is the life-blood of a country. It is responsible for the flow of credit and for maintaining the financial balances of the economy. In India, since the nationalization process banks emerged as a instrument of economic development along with social justice. Corporate Governance has become very vital for banks to perform and stay in competition in this age of liberalization and globalization. Banks have always an important role in corporate governance of companies in as much that strong creditors are as critical to the efficient functioning of enterprises as are strong owners. At the same time as control by equity holders is appropriate in profitable times, the creditor monitoring and control become critical at all times.

Ownership pattern, regulatory environment, societal pressure on the developmental role of banks and the broad structure would be the key attributes in the design of a governance framework of banking. While government ownership does provide core strength to banks, the structural inefficiencies and lack of management autonomy appears to have weakened the capability of our banks especially of Public sector to compete efficiently in the current market situation. Banks and financial institutions have been making essential contributions over the years to nation's economic growth and development. Government-owned (Public Sector) banks have played a major role in economic development. During the last few years, these institutions are slowly getting *"corporatized*" and consequently corporate governance issues in banks assumes greater significance in the coming years. Observing the importance of banking sector the practice of corporate governance and how it assists banking industry in India in terms of bringing more transparency and overall development of banking sector. Thus, the dissertation will identify the attributes of corporate governance and to what extent it is being implemented in India's banking sector.

[33] *edissertations.**not**tingham.ac.uk/1888/1/08MAlixpg3.pdf.pdf*
[34] *Ibid*
[35] *Ibid* 1

6. CORPORATE GOVERNANCE OF BANKS IN INDIA

This chapter will deal with all pre-requisites for good corporate governance in banks such a) as a proper system consisting of clearly defined and adequate structure of roles, authority and responsibility, b) Vision, principles and norms which indicate development path, normative considerations and guidelines and norms for performance, c) a proper system for guiding, monitoring, reporting and control.

The OECD paper, 1999 defines corporate governance as involving a set *of* relationships between a company's board, management, shareholders and *other* stakeholders. Building on this framework, the Basel Committee on Banking Supervision also issued a paper in 1999 to assist the supervisory authorities in different countries in promoting the adoption of sound corporate banking practices by banking organizations in their countries. The Basel Committee paper includes bank-specific concerns. It suggests desirable practices to be adopted by banks to safeguard the interest *of* not only the stakeholders but also the depositors by ensuring that the various activities and behaviours *of* banking organizations match their expectations *of* banks operating in a safe and sound manner in compliance with applicable laws and regulations.[36] II Banking business is different *from* other *forms of* business in some important aspects. As banks provide a payment and settlement system to the economy and have important linkages with the real sector, they are subject to a higher degree *of* regulation than *other* enterprises.[37]In other words regulators have a high stake in safeguarding the stability and soundness of banking system. Banks are repositories of public funds and are engaged in the business *of* using other peoples' money *for* deployment and earn a spread in the process. Therefore, the elements of public interest and trust are more evident and explicit in banking than in other, conventional *forms* of business *or* enterprise. Being an important organ *of* society, banking may be regarded as a "social partnership" among the various stakeholders *for* creation *of* wealth.[38] Consequently there is a very large number *of* individuals and groups, which is affected by the operations *of* banks as compared with other businesses. The Basel Committee also reiterates that due to the unique role that banks play in national and local economies and

[36] K.M. Bhattacharya "Corporate Governance in Banks: Concepts and Issues" in Ramesh K. Arora and Tanjul Saxena edn., *Corporate Governance: Issues and Perspective,* Mangaldeep Publicatios, 2004 p. 176-182
[37] *Ibid*
[38] *Ibid 1*

financial system, the supervisors and governments should also be recognized as stakeholders in the context of banking companies. Thus, apart *from* internal stakeholders viz. the employees, a bank has external stakeholders in the *form of* shareholders, customers, regulators, competitors and the community in general. These stakeholders place varying demands on the banking operations which sometimes are in conflict with one another. Corporate governance therefore seeks to strike a match between these expectations. These expectations can be classified according to the primary and secondary nature *of* their demands, which need to be taken into account in corporate governance *framework for* banks. One strict classification is given below:

STAKEHOLDERS EXPECTATIONS[39]

Stakeholders	Expectations	
	Primary	Secondary
Shareholders	Financial Return	Added Value
Customers	Courteous Service	Quality Improvement
Employees	Pay and Job Security	Work Satisfaction
Regulators 0,	Compliance	Stability
Competitors	Fair Play	Market Expansion
Community	Economic Growth	Support to Community

Besides these, banks were statutorily required to take constructive interest in aspirations of the society through a system of directed credit and subsidized interest rates for needy sectors. The developments which have taken place since 1991 have changed the pattern of investment as also of shareholding not only in the corporate sector but also in the banking sector. The process of corporatization of banks particularly the Government-owned ones is expected to gain further momentum as the recommendations of Narsimham Committee(II) are implemented. In the context of public sector banks this committee also observed that unlike in other' countries where there is separation of ownership and management, in India ownership has become an instrument of management. Thus the distinction between ownership, responsibility and management duties has got blurred and banks are found wanting in responding to the changing environmental situation. Towards this end the committee has suggested that the Government should maintain “arm’s length relationship” with banks by divesting its holding up to 33 percent.[40] Consequently the issues of corporate governance will assume greater significance and importance in the banking system. There will be a large body of shareholders wanting to have some control on the banking companies either directly or indirectly through non-executive independent directors. Assertion of shareholders' rights is spreading worldwide through foreign institutional investors and India is no exception. So banks must take note of and acquaint with changing expectation profile of shareholders. These nonexecutive directors would have the responsibility of controlling the management and see that it performs adequately. Moreover with the change in shareholding pattern there has developed a large - body of highly - professional and knowledgeable investors demanding greater transparency and much more information.

At the same time the gradually tightening regulatory framework will become an even more important factor in influencing corporate governance. The role of the regulator in corporate governance encompasses financial regulation including the formulation and enforcement of rules and standards governing financial behaviour as well as the ongoing supervision of individual institutions. Prudential norms and standards of high quality are also required to assure market participants including various stakeholders that sound financial practices are being applied thereby increasing market confidence in the country's overall financial health.19 Disclosure and transparency are two of the key pillars of a corporate governance framework because they provide the stakeholders with the information necessary to judge whether their interests are being taken care of. In this respect it is seen that since the introduction of liberalization measures following the reforms in the banking sector the extent of disclosures have been enhanced gradually. Banks have now to disclose significant data such as capital (Tier I and II), Capital Adequacy Ratio, movements of NP As and investments, Critical Operating Ratios, Productivity Ratios, maturity pattern of assets and liabilities, foreign currency liabilities and exposure to sensitive sectors.

Further in the light of deregulation of interest rates and greater autonomy being given to banks the role of board of directors in banks has become significant. Through various measures the RBI has emphasized the primacy of the board of directors and its essential role as the instrument of corporate governance in banks. The insertion of a new clause 49 of listing agreement providing for *inter alia,* appointment of independent directors is significant in this context. The independent non-executive directors are meant to provide the - board the benefit of their experience and expertise and bring objectivity in decision making. Unfortunately the remuneration paid to such directors is too small to attract the best talent available for such onerous positions. The banks' boards have been required to lay down policies in critical areas like investments, loans, asset-liability management, risk management and management of recovery and NPAs. The CAMELS rating process of banks recently introduced takes into account the working and effectiveness of the board and its committee’s namely the Audit Committee,

[39] *Supra note 31*
[40] M. Narsimhan Report of the Committee on Banking Sector Reforms (1998)

Compensation. Committee, Nomination Committee and the Risk Management Committee which is specific to banks. The board structure in an individual bank would mainly depend on how the bank is going to position itself amidst the wide spectrum ranging from Niche Banking to universal mode. Some of the options available to the banks in this context have been outlined by Ravi Shankar which include:

- Remaining as an independent entity and build on core strengths and exit from unprofitable services products locations.
- Strike strategic alliances with others in the market to offer their products to its own customers using the branch network advantage.
- Hook on to the communications/ATM/Optical Fibre Network established by other players to provide convenient and speedy service to customers.
- Be a Niche Bank offering a few self-branded products in homogeneous geographical segments.
- Tie up with a strategic foreign/domestic partner to gain access to the latest banking technology products and expertise.
- Merger with/acquisition of one or two bigger/smaller banks to get size advantage, broaden core competencies, get wider geographical coverage and/or derive economies of scale in operations. Alternatively a holding company format for retaining the identity and brand equity of individual units may be considered.
- Raise equity in the capital market and in the process reduce the promoters' stake in the bank to enable comfortable balance sheet expansion by meeting capital adequacy norms and to introduce corporate governance principles in management.
- Shed some part of the equity in favour of a few stronger players in the market to ward off potential take-over threats.
- Leverage the existing branch network to also provide other services/ products not necessarily related to banking.

As all our banks are currently positioned across a wide spectrum ranging from "survival and sustenance needs to growth and globalization possibilities," individual bank level strategies would be determined more by the owners and regulators at one end and perhaps by the management and market at the other. The merger between Bank of Madura and ICICI Bank, the alliance between the Corporation Bank and LIC of India and the recently reported attempts by IDBI to take over a giant public sector bank are some recent examples of such options being exercised.

On the background of organizational restructuring of banks the boards will require to take into account the fact that till the advert of economic and financial sector reforms coupled with technology, the size of a bank is more determinable in terms of market share of business than anything else." In the emerging market, competitiveness is likely to result in thinner margins and all things remaining same "the risk bearing capacity of a bank improves with asset size and/or market share of business." As a result, due to vast divergence, the Indian market still holds scope for well managed small size banks with a specific localized core competency to survive on a regional basis and the code for corporate governance when adopted by them can enable them to succeed.

All said and done as Malegam aptly states "Corporate Governance cannot be purely regulatory. It has to be a way of life."

With governance becoming an important subject, banking supervisors themselves are concerned with how to improve standards with respect to corporate governance in banks. Governance in banks is determined by the system of processes and controls established internally and externally over its management. It needs to be noted that banking is different from other forms of business in some important respects. Banking has commonly been treated as a matter of public interest given the overall importance of banks to the economy both in regard to its linkages with the real sector and for providing a payments and settlement system. It is for these reasons banks are subject to a higher degree of regulation than other enterprises.

The foundation of good institutional governance in banks is a sound business strategy and a competent and responsible management. Good governance in banks also requires comprehensive internal control procedures and policies that are implemented by skilled personnel and monitored by management. Effective risk management by financial institutions is crucial and becomes even more critical as well as complex as markets develop.

External auditors play a vital role in the maintenance of overall soundness of the system. Apart from giving an opinion on "true and fair" view of the bank's financial position auditors are also required to verify compliance with regulatory requirements. The responsibilities devolving on auditors have enlarged and it is important that auditors become fully aware of the expectations of the owners of banks and the supervisory authorities.

The role of the supervisor in corporate governance encompasses financial regulation including the formulation and enforcement of rules and standards governing financial behavior as well as the ongoing supervision of individual institutions. Financial regulation and supervision play an essential role in fostering financial health. They make the financial system strong and resilient. The role of the supervisor is also to ensure that banks implement sound accounting principles, ensure minimum level of disclosure and lay down a comprehensive set of prudential norms and standards. In the absence of such norms and standards the supervisor cannot exercise his powers and responsibilities in a coherent fashion. These norms and standards need to be objective, internally consistent, transparent and well understood by those to whom they are applied. Prudential norms and standards of high quality are also required to assure market participants including stakeholders that sound financial practices are being applied thereby increasing market confidence in the country's overall financial health. It also helps promote a level playing field and fair competition among institutions of a similar type. Supervisors should also enforce strictly these norms and standards. They should have the authority to impose penalties for non-compliance. The penalties could be in the form of fines removal of management in cases of unsafe or unsound banking practices and limiting the activities permitted and in extreme cases closure.

As of a banking industry point of view, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:[41]

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business;
- consider the interests of recognized stakeholders;
- align corporate activities and behaviors with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- Protect the interests of depositors.

Banks are critically vital for industrial expansion, the corporate governance of firms, and capital allocation. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation, and stimulates productivity growth. Therefore, the functioning of banks has implications for the operations of firms and the prosperity of nations. Given the importance of banks, the governance of banks themselves assumes a central role.

If bank managers face sound governance mechanisms, they will be more likely to allocate capital efficiently and exert effective corporate governance over the firms they fund.[42] In disparity, if banks managers enjoy enormous discretion to act in their own interests rather than in the interests of shareholders and debt holders, then banks will be correspondingly less likely to allocate society's savings efficiently and exert sound governance over firms.[43]

Banking crises significantly advertise the massive consequences of poor governance of banks. Banking crises have crippled economies of even developed countries, destabilized governments, and intensified poverty. When bank insiders utilize the bank for their own purposes, this can increase the probability of bank failures and thereby curtail corporate finance and economic growth. While banks are important, this alone does not motivate a separate analysis of the governance of banks. Banks are firms. They have shareholders, debt holders, boards of directors, competitors, etc. It is submitted that one can simply think about the governance of banks in the same manner that one thinks about the governance of a shoe company, or an automobile company, or a pharmaceutical company.

7. CENTRAL ISSUES IN CORPORATE GOVERNANCE IN BANKS

7.1. The Governance of Banks: Special Features

As we know, banks have two qualities that motivate a separate analysis. Purposely, banks are generally more opaque than non-financial firms and governments heavily intervene in the banking industry more frequently. So, the implications of these qualities for the governance of banks are as follows:

7.1.1. Opaqueness of Banks: Implications for Corporate Governance

7.1.1.1. Opaqueness: Implications for governance by equity and debt holders

The greater informational irregularities between insiders and outsiders in banking make it very difficult for diffuse equity and debt holders to monitor bank managers. Thus, controlling owners have incentives to increase the bank's risk profile. Debt holders,

[41] http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023826.pdf

[42] http://www.econ.brown.edu/fac/Ross_Levine/finance/rlevine/Publication/2003_GCGF_Governance%20of%20Banks.pdf

[43] Supra note 36

though, do not enjoy any advantageous potential from risk taking but do on the disadvantage if the bank cannot pay its debts. The bigger cloudiness of banks makes it harder for debt holders to control banks from this risk shifting.

In terms of incentive contracts, major informational irregularities make it more difficult to design contracts that align managers' interests with bank equity holders.[44] When outcomes are difficult to measure and easy to influence in the short-run, managers will find it easier to manipulate pay-offs from 'compensation' packages.[45] Bankers who are interested in boosting their compensation in the short run can give a high interest loan to a borrower in trouble, thereby boosting interest income. And by controlling significant pools of resources, bankers can move asset prices that trigger payments to themselves under incentive contracts. Furthermore, since managers frequently control the boards of directors that write the incentive contracts, managers of opaque banks can often design compensation packages that allow managers to benefit at the expense of the long-run health of the bank.

Many people believe that large creditors e.g., holders of subordinated debt and debentures can ease informational irregularities in banks and boost corporate governance, there are complicating factors. Large creditors rely on legal systems that are frequently unable to support their rights, with adverse implications for corporate governance. Also, large creditors may use their insider status to benefit themselves at the expense of the less-informed investors and efficient corporate governance.

Beyond these complicating factors, there are other difficulties associated with relying on subordinated debt to improve governance as discussed below.

Opaqueness also makes it easier for insiders to exploit outside investors and the government. In so many nations, the domination of large sectors of the economy by relatively few families makes insider abuses more likely, most often at the expense of outside equity investors, depositors, and ultimately taxpayers.[46]

7.1.1.2. Opaqueness: Implications for governance by competition

The dullness of banks can weaken competitive forces that, in other sectors, help discipline managers through the threat of takeover as well as through competitive product markets. Product market competition is frequently less intense in banking. Bankers typically form long-run relationships with clients to restructure the informational problems associated with making loans – and these relationships represent barriers to competition.

Takeovers are likely to be less effective when insiders have much better information than potential purchasers. Even in industrialized economies, hostile takeovers tend to be rare in banking. Indeed, long delays in the regulatory approval process associated with bank purchases makes hostile takeovers in banking extremely rare.[47] Post-failure takeover, which is happening with greater frequency, almost by definition, does not affect managerial incentives.

In addition, the absence of an efficient securities market hinders takeover and hence corporate governance. If potential corporate raiders cannot raise capital quickly, this will reduce the effectiveness of the takeover threat. Similarly, if bank shares do not trade actively in efficient equity markets, this will further hinder takeovers as an effective governance mechanism.

Furthermore, the absence of efficient securities markets means that many financial instruments such as subordinated debt and debentures that might be used to limit managerial discretion do not exist. There subsist good motivations for creating a group of large, uninsured creditors with the incentives and ability to monitor banks as a plan for enhancing corporate governance. Nevertheless, this plan assumes the subsistence of efficient securities markets, which do not subsist in most of the nations.

7.1.2. Bank Regulation: Implications for Governance

***7.1.2.1* Regulation: Implications for governance by shareholders and competition**

Though intense equity is a common corporate governance mechanism for dealing with the incapacity of diffuse equity holders to exert effective corporate control, most governments restrict the concentration of bank ownership and the ability of outsiders to purchase a substantial percentage of bank stock without regulatory approval. These restrictions may arise due to concerns about concentrations of power in the economy or about the type of people who control a bank. These restrictions are put into effect usually by requirements that purchasers of bank stock have to alert government officials as their holdings increase above a certain level, and may need regulatory approval above some proportion. Moreover, there may be constraints on who can own banks, such as the prohibition on ownership by nonbank firms, or by securities firms or insurance companies in some countries like U.S. has done recently.

[44] Supra note 36
[45] *Supra note 36*
[46] *Supra note 34*
[47] Supra note 34

However, a wicked absurdity seems to operate, government regulatory restrictions are often inefficient at limiting family dominance of banks, but the regulatory restrictions on purchasing equity actually protect these family-controlled banks from takeover and hinder corporate governance. There are lots of channels by which powerful families have built up control in banks and nonbank firms, as in the case of East Asia.[48] Among all these controlling owners, more than half are families. The regulatory restrictions on share purchases, therefore, do not avert family ownership but moderately defend the existing owners from competition for control.

7.1.2.2 Regulations: Implications for governance by depositors

Deposit insurance implicit or explicit substantively changes the equity and debt channels of corporate governance in a number of manners:[49] First, deposit insurance reduces the incentives of depositors to monitor banks, which directly hinders corporate governance. Second, deposit insurance induces banks to rely less on uninsured creditors with incentives to monitor and more on insured depositors with no incentives to exert corporate governance. Third, deposit insurance along with the rise of central banks as lenders of last resort have helped produce banks with very low capital-asset ratios relative to other firms. As capital-asset ratios fall, this increases the incentives of controlling owners to increase the riskiness of the bank. Therefore, deposit insurance both increases the ability of owners to increase risk because depositors no longer have incentives to control and deposit insurance increases the incentives for bank owners to increase risk because of lower capital-asset ratios. That is why; countries with more openhanded deposit insurance tend to have a higher probability of suffering banking crises.

7.1.2.3 Regulation: Implications for competition

Many government interventions limit competition in banking. Governments regularly restrict ownership concentration and regulate who can own banks. This impedes competition for corporate control. In terms of reducing competition in output markets, many nations impose regulatory restrictions on banks' ability to underwrite equity, conduct real estate or insurance business, or take ownership in nonbank firms. Furthermore, many countries impose minimum branching requirements, directed credit guidelines, portfolio, liquidity requirements, and limits on interest rates and fees. Despite the fact that there may exist sound motivations, the regulating-hand of the government frequently restricts competition and thereby hinders a key corporate governance mechanism.

[48] Supra note 34
[49] Supra note 36

8. MEASURES TAKEN BY BANKS TOWARDS IMPLEMENTATION OF BEST PRACTICES

This chapter would be dealing following practices of banks: Prudential norms, Capital Adequacy, ALM and Risk Management Practices.

- Prudential norms- All norms in terms of income recognition, asset classification, and capital adequacy have been well absorbed by the Indian banking system. In line with the international best practice, starting 31st March 2004, banks have recognised 90 days norm for classification of NPAs. Also, norms which govern the provisioning requirements pertaining to doubtful assets have been made stricter in a phased manner. Banks will be required to set aside capital charge for market risk on their trading portfolio of government investments, which was earlier virtually exempted from market risk requirement.

- Capital Adequacy- All the Indian banks except one today seem well above the stipulated yardstick of 9 per cent and happens to be in a state of readiness so as to achieve the best standards of CRAR as soon as the new Basel 2 norms are made operational. In fact, as of 31st March 2004, banking system as a whole had a CRAR close to 13 per cent.

- On the Income Recognition Front- There is solid uniformity now in the banking industry and the system therefore ensures responsibility and accountability on the part of the management in proper accounting of income as well as loan impairment.

- ALM and Risk Management Practice-, banks were supposed to quickly address the very need for Asset Liability Management followed by risk management practices. At the proposal of the regulators. Both these are serious areas which need attention for an effective supervision by the Board and the senior management which are duly implemented by the Indian banking system on a tight time frame and the implementation review by RBI. These steps have made the banks stronger to understand, measure and anticipate the impact of the interest rate risk and liquidity risk, which in deregulated environment is gaining

8.1. Quality and concentration of ownership

The ownership issue in banks includes a few crucial issues that have been engaging the attention of public and a policy environment is being sought to be so created that would confirm to the best principles of governance. Unique corporate governance challenges are posed where the ownership attribute lacks transparency or where there insufficient checks and balances on improper influences of controlling shareholders. While there can be different opinions on the issue of concentrated ownership but there is clear recognition that major shareholders should pass the fitness and propriety tests.

The current legal and policy framework with respect to ownership in banks, at a sectoral level, involves the following:

(i) Voting rights restriction as per banking laws

In terms of the statutory provisions under the various banking acts, the voting rights, when exercised, have been specified as under:

Private Sector Banks – [Section 12(2) of Banking Regulation Act,1949]	No person holding shares, in respect of any share held by him, shall exercise voting rights on poll in excess of ten percent of the total voting rights of all the shareholders.
Nationalised Banks – [Section 3(2E) of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80]	No shareholder, other than the Central Government, shall be entitled to exercise voting rights in respect of any shares held by him in excess of one percent of the total voting rights of all the shareholders of the nationalised bank.
State Bank of India (SBI) - (Section 11 of State Bank of India Act,1955)	No shareholder, other than RBI, shall be entitled to exercise voting rights in excess of ten percent of the issued capital, (Government, in consultation with RBI can raise the above voting right to more than ten percent).
SBI Associates - [Section 19(1) and (2) of SBI (Subsidiary Bank) Act, 1959]	No person shall be registered as a shareholder in respect of any shares held by him in excess of two hundred shares. No shareholder, other than SBI, shall be entitled to exercise voting rights in excess of one percent of the issued capital of the subsidiary bank concerned.

(ii) Acknowledgement of RBI for transfer of shares more than 5%

The Central Bank of India had issued guidelines in September 1999 with respect to the private sector banks, on the grant of acknowledgement for acquisition and transfer of shares. it is to be noted that in all cases of acquisition of the shares which would take the aggregate holding (direct and indirect, beneficial or otherwise) of an individual or group to equivalent of 5 percent or more of the paid-up capital of the bank the acknowledgement from central bank is needed. For greater limit, 10% and 30%, increasingly strict criteria must have to be adopted for considering granting of acknowledgements.

(iii) Restrictions on cross holdings

A bank's overall investment may be permitted up to the 10 % of the investing bank's capital funds in the below mentioned instruments being issued by the other banks and financial intuitions. These are:

- Equity shares;
- Preference shares eligible for capital status;
- Subordinated debt instruments;
- Hybrid debt capital instruments; and
- Any other instrument approved as in the nature of capital.

8.2. Board of Directors

The very structure in order to ensure the effective supervision by the Board of Directors incorporates the following things:

- Statutory requirement with respect to composition of Board of Directors
- BOD sets the strategic aims and a set of corporate values that are communicated throughout the banking organisation.
- BOD is under an obligation to understand the risk profile of the institution and must ensure adequate capital to cover the risk.
- Unique task when the institutions have intricate corporate structures. Where a bank happens to be a part of a wider group either as parent or subsidiary a number of of issues arising from the corporate governance angle in that there is every chance to affect to a certain limit structure and activities of both parent and subsidiary boards. Need for effective and sound control of subsidiaries by the parent board.
- Too much outsourcing of intragroup activities that might cause concerns from the point of view of the supervisors
- Group dimension might also create conflict of interest within the Group which must be taken care of
- Guidelines with respect to the criteria for appointment of directors, role and responsibilities of directors and the Board
- Covenants & undertaking: A declaration and undertaking needs to be obtained from the proposed / existing directors. The directors are supposed to executing a covenant which would be binding on them to carry out their responsibilities to the best of their abilities,. Further it is to be observed that the issue pertaining to the wide issue of fit and proper position of directors and signing of the

covenants ought to be one of the main criteria to be eligible to be a director of a bank. The board of the bank need to ensure in public interest that the nominated / elected directors for executing the deeds of covenant that have been so recommended by Dr. Ganguly Group.

- Training / Seminars: Generally the banks are advised to ensure that the directors should be exposed to the current much needed managerial techniques, technological developments in banks, and financial markets, risk management systems etc. so as to discharge their duties to the best of their abilities. While RBI could offer certain training programmes/seminars with this regard at its training establishments, large banks might be conducting such programmes in their own training centres.

- In 1995, Audit committee of the Board banks were directed to set up Audit Committees of their Boards by the RBI with the task to ensure the efficacy of the internal regulation and audit functions in the bank in addition to adherence 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 compulsory members, but the Chairman cannot be part of the Audit Committee. Apart from the above, Board level committees that need to be set up are Risk Management committee, Asset Liability Management committee (ALCO), etc. The Boards are also given the freedom to constitute any other committees, to provide advice to it as it deems fit.

- Ensure the Sound practices for CR, MR and OR management emphasizing role of Board & Senior management: being the primary responsibility for laying down risk parameters and establishing an integrated risk management and control system rests with the Board of Directors, the banks were advised that all assessments of the risk management systems need be placed before the Board. On the basis of such evaluation banks should be initiating required steps, with the approval of their Board, to remove the pitfalls in compliance with the risk management guidelines being issued by RBI and ensure that they have efficient and strong risk management systems in place.

- There has to be 'Fit and proper' assessment in respect of all persons to be appointed on the Boards of private sector banks,

- The earlier practice of RBI nominating directors on the Boards of all private sector banks has seen place to such nomination in select private sector banks.

8.3. Quality of management

Senior management consists of a core group of individuals who are responsible for the day to day activities of the bank should be having required skills and oversee line managers in specific business areas and activities consist with policies and procedures being laid down by the Board.

- Senior Management sets out the effective mechanism of internal regulations

- There has to be Fit and proper regulations for CEO and directors being laid down in terms of circular dated June 25, 2004. It was provided that '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 need to be seriously considered as a formal process.'

- Prior approval of Reserve Bank of India is needed for appointment of CEO as well as terms and conditions thereof.

- Powers for removal of managerial personnel, CEO and directors, etc. in the interest of depositors.

8.4. Prudential standards

Capital regulation is governed by a principle that the owners would supervise if they have much at stake either in the form of capital or future profits. Hence, there should be emphasis on capital adequacy. The need is felt for prudential norms on income recognition and asset classification and provisioning is required because of the very nature of bank balance sheets-loan assets do not lend themselves to proper valuation. Appropriate accounting standards, connected and related party transaction regulations, risk based supervision enforcement of corporate governance rules are considered to be vital for promoting sound corporate governance. In fact the importance of corporate governance proceeds with the Core Principles for banking Supervision against which we assess our practices. However, regulation cannot be an option for corporate governance.

9. MEASURES TAKEN BY REGULATOR TOWARDS CORPORATE GOVERNANCE

Regulators happen to be external pressure points for good corporate governance. Mere compliance with regulatory requirements is not however could be an ideal situation in itself. In fact, mere compliance with regulatory pressures is just a minimum requirement in pursuance of good corporate governance and what are required are internal pressures, peer pressures and market pressures to reach higher than minimum standards as prescribed by regulatory agencies.

RBI's approach to regulation in recent times has some unique features that will certainly foster the need for and worthiness of good corporate governance in the co-operative sector. The transparency aspect has well been stressed upon by extending the coverage of information and timeliness of such information and analytical content. Importantly, deregulation and operational freedom must go in tone with operational transparency. Which is much needed for the good governance In fact, the RBI has made it clear that with the abolition of minimum lending rates for co-operative banks, it would be incumbent upon these banks to make the interest rates charged by them transparent and known to all customers. Banks have therefore been told to publish the minimum and maximum interest rates charged by them and display this information in every branch.

Disclosure and transparency are thus key pillars of a corporate governance framework because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of. RBI's transparency and disclosure is as an important adjunct to the supervisory process as they facilitate market discipline of banks.

The Reserve Bank of India has taken many steps in order to enhance corporate governance in realm of Indian Banking System. These can well broadly be divided into the following three categories: a) Transparency b) Off-site surveillance c) Prompt corrective action.

The significance attached to corporate governance in banks is being mirrored in the fact that the Reserve Bank had been able to constitute at least three committees/ working groups in order to evaluate and make appropriate recommendations. These are:

- 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. Further an Advisory Group on Corporate Governance (Chairman: Dr. R. H. Patil) made comprehensive evaluation and gave recommendations of which those relating to PSBs is an important factor

- The Advisory Group on Banking Supervision (Chairman : Mr. M.S. Verma) has also made some recommendations on corporate governance.

- A Consultative Group of Directors of banks and financial institutions (Chairman Dr. A.S. Ganguly) was constituted with a view to the review the supervisory role of Boards of banks and financial institutions and in order to obtain feedback on the effective 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 Groups constituted submitted their recommendations after a comprehensive review of the existing framework also looking at the current practices and gave the recommendations with international best practices as articulated 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 Groups come out with 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, changes that might be brought about within the existing legislative framework have been implemented.

Another key area which requires much needed attention is greater transparency in the balance sheets of co-operative banks. it is always argued that transparency is must for any governance The commercial banks in India now ought to disclose accounting ratios pertaining to operating profit, return on assets, business per employee, NPAs, etc. as also maturity profile of loans, advances, investments, borrowings and deposits. The serious issue before regulators is how to adapt similar disclosures so that it can be reflected in the audit reports of co-operative banks. Having taken note of it RBI had advised Registrars of Co-operative Societies of the State Governments in 1996 that the balance sheet and profit & loss account ought to be well prepared based on prudential norms which were introduced as a sequel to Financial Sector Reforms and it is imperative the statutory/departmental auditors of co-operative banks must carefully look into the compliance with these norms. Auditors are supposed to be abreast with all aspects of the new guidelines issued by RBI and with a view to ensure that the profit & loss account and balance sheet of cooperative banks are well prepared in a transparent or opaque manner and reflect the true state of affairs. Auditors must also ensure that other necessary statutory provisions and appropriations out of profits are made as required in terms of Co-operative Societies Act / Rules of the state concerned and the bye-laws of the respective institutions. Hence, RBI has a very crucial role to play in better governance of the banks.

10. SUGGESTIONS TO IMPROVE CORPORATE GOVERNANCE PRACTICES IN BANKS

Something should be done for better internal checks and balances, better auditing, better transparency, better enforcement of policies, better action over NPAs, timely action against frauds. It is suggested that corporate governance reforms may be a prerequisite for the successful divestiture of government ownership. Furthermore, it is also suggested that the increased competition resulting from the entrance of foreign banks may improve the corporate governance of developing-economy banks.

Chairman and CEO

It has been recognized that there has to be separation of the role of Chairman and CEO. Cadbury Committee on corporate governance contemplates that there should be a clearly accepted segregation of responsibilities at the head of the company level, which would aim to ensure a balance of power and authority, such that no one individual can have the arbitrary powers of decision-making. At present in India, in most of the banks, the CEO and the chairman's positions are combined. It is common practice that the government appoints the chief executives of public sector banks and has preferred the composite position of chairman and managing director.

Responsibility of the Board

According to the Board of International Settlement (BIS) code, bank boards should set out the strategic aims and objectives must also set corporate values that would monitor the ongoing activities of the bank. The board has to ensure that senior management serious implements the policies that explicitly ban the activities and relationships that could lessen the quality of corporate governance, such as conflicts of interests, self-dealings and preferential dealings with related parties. In tone with their supervisory role of board of directors should feel empowered paving the way to recommend sound best practices, provide dispassionate advice and avoid conflicts of interests.

Accountability to Shareholders/Stakeholders

The Securities and Exchange Board of India (SEBI) has come with guidelines in which it provides that the Board ought to be responsible to shareholders in bid to create, protect and enhance the wealth and resources for the company and reporting them on the performance in timely manner and most importantly the transparency must be observed. But it is often noticed that the majority of banks, Boards do not enforce the clear lines of responsibility and accountability for themselves.

Election

The Organization for Economic Co-operation and Development (OECD) principles suggest that the Board needs to ensure a transparent Board nomination process. In terms of the provisions of section 9 of the Banking Companies (acquisition and Transfer of Undertakings) Act, the government constitutes the Boards of Directors of nationalized banks. The Boards comprise of two whole-time directors, a nominee each of the Government of India and the Reserve Bank of India, nominees of workmen and non-workmen unions, and a chartered accountant.

In addition to this, six non-official directors with specialized knowledge in agriculture and rural economy, banking, co-operation, economics, finance, law, etc. are appointed. Present situation is that the bank board's consist mainly of nominated members and not the elected members. Moreover, banks do not have nomination committees for nominating directors of Boards of banks.

Audit Committee

According to BIS the Audit Committee of banks need provide the control and supervision of the banks' internal and external auditors. It could further approve their appointment and dismissal, review and approve the audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective preventive actions in a timely manner. The independence of this committee can be further fostered up when it is comprised of external Board members who have banking and financial expertise. In India, the banks are under obligation to set-up an Audit Committee of Board of Directors to oversee and provide direction to the internal audit/ inspection function in banks in bid to enhance its effectiveness as a management tool.

Corporate Governance paves the way for a paradigm change in the role of the Board and corporate directors. They have to be "evolutionary" and "revolutionary" continuously to move the banks toward high level of creativity where the transparency and independence could be observed. While corporate governance is considered to be vital which can be a tool for the long term financial health of banks, it is only a part of larger economic context in which bank operate. The Corporate Governance solely depends upon legal and institutional mechanism the strong the legal mechanism the greater transparency and good governance. It may be rightly to conclude with the remarks that the very path to efficacy lies with minimizing regulatory prescription and maximizing voluntary codes to ensure perfection in corporate governance among financial intermediaries. Corporate Governance is the only the effective path where the success of the corporate sector could be gauged upon.

11. CONCLUSION

Corporate governance has got momentous role to play with the rapid globalisation and liberalisation. The strong and emerging economy has also strived to be in line with WTO needs, if at all the Indian corporate bodies have to survive and succeed amidst growing environment of competition; it would only be possible by transparency in operations. It may further be concluded that the important areas like customer satisfaction, in terms of return, in terms of product and service, in terms of return to promoters and in terms of social responsibilities towards society and people can never be achieved without practicing good corporate governance. The aforesaid areas are of the paramount significance which need to be taken care of with good governance. There are effective legal, regulatory, and supervisory policies influence the operational efficiency of banks. This dissertation has delineated that banking institutions necessitates a broader prospective of corporate governance where regulation of banking mechanism should protect the interests of the depositors.

The protection of the concerns of the of depositors in a deregulated environment is usually provided by a system of prudential regulation and norms, but in developing countries such protection is being weakened by the utter lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank funds and the presence of distributional cartels. In order to deal with these problems, the developing economies need to adopt the following measures:

- Liberalisation policies need to be regular, and should be dependent upon improvements in prudential regulations.
- Developing countries need to apply resources enhancing quality of their financial reporting systems, as well as the quantity and quality of bank supervisors.
- Given that bank capital plays such an important role in prudential regulatory systems, it may be necessary to improve investor protection laws, increase financial disclosure and impose fiduciary duties upon bank directors so that banks can raise the equity capital required for regulatory purposes.

It is suggested that the corporate governance of banks in developing countries is severely affected by political considerations. Firstly, given the drift towards privatisation of government-owned banks in developing countries, there is a dire requirement for the managers of such banks to be granted autonomy and be gradually introduced to the corporate governance practices of the private sector prior to divestment. Secondly, where there has only been partial divestment and governments have not relinquished any control to other shareholders, it may prove very difficult to divest further ownership stakes unless corporate governance is strengthened. Finally, given that limited entry of foreign banks may lead to increased competition, which in turn encourages domestic banks to follow the corporate governance practices of their foreign competitors, it is suggested that developing countries partially open up their banking sector to foreign.

The research on corporate governance in Indian Banking Sector has shaped some important results. Banking has become intricate and it has been identified that there is a need to attach more importance to qualitative standards such as internal controls and risk management, composition and role of the board and disclosure standards. Corporate Governance has become very vital for banks to perform and remain in competition in the age of liberalization and globalization. The success of corporate governance rests on the awareness on the part of the banks of their own accountability and responsibilities. While law can control and regularize practices only to a certain level, the ultimate duty of being ethical and moral remains with the banks. It is this illumination that would bring banks closure to their goals. However, while all this looks good on paper, it runs into considerable difficulty during performance. This difficulty is compounded given the fact that there are easier ways, which give faster returns that are no less valuable because they are acquired through questionable means.

Further, the outcome of the present dissertation in achieving the objectives of the research establishes some important facts: The first objective of the research was to examine the effectiveness of attributes of corporate governance in Indian Banking sector in bringing transparency and economic growth. It indicated that corporate governance on Indian Banking Sector is at formative stage compared to developed nations. There should be more transparency and disclosure mechanism in order to avoid even the slightest of financial scam.

As much the economic growth is concerned, there is surely economic growth registered by private sector in terms of penetration and share price rise and establishing strong grip over banking sector. The compliance of certain non-mandatory requirements by ICICI, AXIS and HDFC satisfies that they are fairly serious in bringing about the efficiency in performance of corporate governance attributes.

Approaching to second objective, it is very much clear that the regulatory structure of Corporate Governance in India has given sufficient thought to make sure good governance practices in banking sector so as to protect the interest of stakeholders. Even though all the international code of corporate governance principles is not thoroughly practiced, CII code and clause 49 of mandatory requirement have put sufficient ingredient to ensure good corporate governance in Indian banking sector. However, the shareholding pattern of public sector banks was loaded with government share, where good corporate governance can be countered with difficulty.

Coming to the third objective, the proper performance of corporate governance attributes can minimize fraud and malpractices in banking sector. There are provisions of fraud monitoring committee, risk management committee, investors' grievance committee which can minimize the chance of fraud. Generally, such type of mis-governance is perpetuated when transparency of financial statement is missing or appropriate disclosure of information is not made. However, both private and public sector banks are practicing all mandatory requirements of corporate governance mentioned under section 49 of the listing agreement. The opinion of senior executives of different banks were very much optimistic is also in the same direction of achieving excellence irrespective of our little deficiency in adhering such compliances.

There is not much difference in practices of corporate governance by public sector banks and private sector banks. Since banking in India is governed by some statutory act, there is lesser possibility of differences. The degree of applicability of corporate governance principles differs from public sector to private sector, but the transparency and disclosure in public sector is more than private sector. So far as voluntary adherence to corporate governance principles are concerned, there appears to be more effort taken by private sector banks than public sector banks. Slowly and gradually the regulatory authority will make more norms mandatory and compulsory.

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