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Corporate governance in banking sector: A fine-tuning performance

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Abstract
Corporate governance is an age old concept which provides for a set of transparent relationships between an institutions management, its board, shareholders and other stakeholders. Corporate governance is gaining centre stage in the recent times due to failure of corporate and wide dissatisfaction among the people with the way corporate works and hence became a widely discussed topic worldwide. Corporate Governance is now recognized as a paradigm for improving competitiveness and enhancing efficiency and thus improving investors' confidence and accessing capital. Now corporate governance has become a more dynamic concept and a not a mere static one.
Bank and Financial Institutions are the backbone of the economic sector of any country. The healthy economic condition of a nation is depicted through the sound functioning of its banks. Banks form a crucial link of a country's economic sector hence they are universally regulated industry and their wellbeing is imperative for the economy. Working of banks is different from other corporate in many important respects, and that makes corporate governance of bank not only different but also critical. Hence corporate governance is conceptually different for banks. If a corporate fails, the fall outs can be restricted to the stakeholders, but if a bank fails, the impact can spread rapidly through other banks with potentially serious consequences for the entire financial system and the macro economy.
The present paper is divided into different sections. In the first part it discusses about corporate governance, its history in India as well as world. Second part talks about applicability of corporate governance as an internal mechanism in banking sector. In third part it talks about the applicability of corporate governance in the banking sector and the mechanism to be adopted for its dynamic usage and in the last part about the various recent developments of corporate governance in banking sector.

Keywords: corporate governance, banking sector, corporate governance mechanism in banks.

Introduction
Corporate governance has only recently emerged as a discipline in its own right, although the strands of political economy it embraces stretch back through centuries. – World Bank Group. The above mentioned definition makes it clear that corporate governance is an age old concept. As corporations operate and compete in virtually all parts of the world, there has always been a need to develop some governing law and the purpose of that law has been to integrate the legislatively imposed standards with the realities of the market place, so that overall goals would be promoted. Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. It therefore needs to take into account a number of aspects such as, enhancement of shareholder value, protection of shareholders rights, composition and role of board of directors, integrity of accounting practices and disclosure norms and internal control system.

Corporate Governance was brought in limelight through series of corporate failures such as Enron and World. Corn. These companies collapsed because of the corporate mis governance and unethical practices they indulged in. Satyam scandal in India is also the case of corporate mis-governance. Satyam case exposed the complete lack of accountability in the company and raised questions on corporate governance practices of the country.

In a service industry like banking, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the o through which the objectives of the institutions are set, the strategy for attaining them is determined and the performance of the institution is monitored.

Bank and Financial Institutions are the backbone of the economic sector of any country. The healthy economic condition of a nation is depicted through the sound functioning of its banks. Banks form a crucial link of a country's economic sector hence they are universally regulated industry and their well being is imperative for the economy. Working of banks is different from other corporate in many important respects, and that makes corporate governance of bank not only different but also critical. Hence corporate governance is conceptually different for banks. If a corporate fails, the fall outs can be restricted to the stakeholders, but if a bank fails, the impact can spread rapidly through other banks with potentially serious consequences for the entire financial system and the macro economy. Thus though various guidelines are provided for working of a bank, corporate governance cannot be overlooked or discarded. Regulations, guidelines and corporate governance are complementary to each other in banking industry.

Virtually every major industrialized country as well as the Organisation for Economic Co-Operation and Development and the World Bank has made efforts in recent years to refine their views on how large industrial corporations should be organised and governed. Academics in both law and economics have also been intensely focused on corporate governance. Oddly enough, in spite the general focus on this topic, very little attention has been given to the corporate governance of bank.

Genesis of Corporate Governance: Before delving further in the concept of Corporate Governance it is important to understand the meaning of the word Corporate and Governance. The word Governance derived from Latin word 'Gubernare' meaning thereby to rule or steer. Governance is a word with a pedigree that dates back to Chaucer and in his day the word carried with it the connotation wise and responsible, which is appropriate. It means either the action or the method of governing and it is in that latter sense that it is used with reference to companies. As per Webster Dictionary 'Corporate' means a body having the nature of, or involving or associated with corporations. A 'corporation' in turn means 'a legal entity that exists independently of the person or persons who have been granted the charter creating it and invested with many of the rights given to individuals. The corporate world comprises of institutions, like companies, firms, proprietorship, etc. Corporate governance is a philosophy by which companies are directed, monitored, managed and controlled. Corporate Governance provides the fundamental framework for the culture of an organization, which ensures efficient functioning of enterprises on sound ethical values and principles. Broadly it is a system of structuring, operating and controlling a company with a view to achieve long-term strategic goals to satisfy shareholders, creditors, employers, customers and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.

From the above discussion it can be seen that it is difficult to define corporate governance with only one definition. Hence there are various definitions of corporate governance as given by various experts from time and again. Some of the important definitions to understand the perspective to corporate governance properly are enumerated here below.

The 1992 Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) describes Corporate Governance "*as the system by which companies are directed and controlled*".

1. Wolfensohn, President, World Bank, has said that "*Corporate Governance is about promoting corporate fairness, transparency and accountability*".

Even the Experts at Organisation of Economic Co-Operation and Development (OECD) have defined "*Corporate Governance as the system by which business corporations are directed and controlled*", it means according to them it is a structure which specifies the distribution of rights and responsibilities among different participants in the corporations.

But today the concept of corporate governance has taken a new dimension and it runs as follows. "*Corporate Governance is the application of the best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders*".

Corporate Governance as per Indian Scenario: In the Indian context, the need for corporate governance has been highlighted because of the frequently occurring scams since 1991 due to emergence of the concept of liberalisation. The scams such as Harshad Mehta Scam, Ketan Parekh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In order to reduce the number the scams in the Indian corporate world, there is a need to induct global standards. From the beginning of 1980s, situation have changed in India. Wide range changes have taken place in both the law and regulations in the field of corporate law and the capital market. As a result of several scams in India a need has arisen to bring reforms, in response to that, reforms begun in India in 1991. The most important event in the field of investor protection in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992. Corporate governance is a multi-faceted subject.

There have been several major corporate governance initiatives launched in India since the mid 1990s. The first was by the Confederation of Indian Industry (CII), India's largest industry and business association, which came up with the first voluntary code of corporate governance in 1998. The second was by the SEBI, now enshrined as Clause 49 of the listing agreement. The third was the Naresh Chandra Committee, which submitted its report in 2002. The fourth was again given by SEBI the Narayana Murthy Committee, which also submitted its report in 2002. Based on some of the recommendations of this committee, SEBI revised Clause 49 of the listing agreement in August 2003. Subsequently, SEBI withdrew the revised Clause 49 in December 2003, and currently, the original Clause 49 is in force.

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

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

- After liberalization, there has been institutionalization of financial markets, FIIs and FIs became dominant players in the stock markets. The market began to discriminate between wealth destroyers. Corporate Governance is a critical by product of market discipline.

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

Indian Banking System: Banks play a pivotal role in the financial and economic system of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Indian banking industry, the backbone of the country's economy has always played a key role in preventing the economic catastrophe from reaching terrible volume in the country. Hence the failure of banks due to unethical or incompetent policies and management action is detrimental to the shareholders, public depositors and the economy at large. Owing to this fact, a proper corporate governance system is crucial for banks and other financial institutions.

History and Evolution of Indian Banking System: Modern banking in India could be traced back to the establishment of Bank of Bengal in 1809, the first joint stock bank sponsored by Government of Bengal and governed by the royal charter of the British India Government. In 1921, Imperial Bank of India was established by merging of three presidency banks. It had multiple roles and responsibilities to be played and also functioned as a commercial bank, a banker to the government and a banker's bank. In 1935 by the establishment of Reserve Bank of India (RBI), the central banking responsibility that the Imperial Bank of India was carrying out came to an end, leading it to become more a commercial bank.

By an act of parliament passed in May 1955, State Bank of India was established in July, 1955. In 1959, State Bank of India took over the eight former state associated banks and its subsidiaries. The decade of 1960s also witnessed significant consolidation in the Indian Banking Industry with more than 500 banks functioning in the 1950s reduced to 89 by 1969. 19 July 1969, was a landmark day for the Indian banking industry as on that day nationalization of 14 major banks was announced. Eight more banks were nationalised in 1980. Regional rural banks came into being in 1976 which allowed the opening of specialised regional rural banks to exclusively cater to the credit requirements in the rural areas. The period following nationalization was characterized by rapid rise in banks business and helped in increasing national savings. There was leapfrogged increase in savings rate, deposits and bank credits. Branch network also expanded significantly which lead to increase in the coverage of banking facilities.

Indian banking, which experienced rapid growth following nationalization, began to face pressures on assets quality by 1980s. Simultaneously, the banking world everywhere was gearing up towards new prudential norms and operational standards pertaining to capital adequacy, accounting and risk management, transparency and disclosure etc. In the early 1990s, India embarked on a ambitious economic reform programme in which the banking sector reforms formed a major part. The Committee on Financial System (1991) more popularly known as the Narasimham Committee prepared blue print of the reforms. A few major aspects of reform included:

- Moving towards international norms in income recognition and provisioning and other related aspects of accounting.
- Liberalization of entry and exit norms leading to the establishment of several New Private Sector Banks and entry of a number of new Foreign Banks
- Freeing of deposits and lending rates (except the saving deposits rate)
- Allowing Public Sector Banks access to public equity markets for raising capital and diluting the government stake
- Greater transparency and disclosure standards in financial reporting
- Suitable adoption of Basel Accord on capital adequacy
- Introduction of technology in banking operations etc.

This led to major changes in the approach of the banks towards aspects such as competition, profitability and productivity and the need and scope for harmonization of global operational standards and adoption of best practices. Significant changes in the strength and sustainability of Indian banking was seen in addition to significant growth in business, Indian banks experienced sharp growth in profitability, greater emphasis on prudential norms with higher provisioning levels, reduction in the non-performing assets and surge in capital adequacy. As a part of the adherence to liberalization of the financial services industry, in the year 2009, Indian banking industry prepared for smooth transition towards more intense competition arising from liberalization.

Indian Banking System at Glance: Banking system forms a strategic building block of the economy. The challenge and complexity of implementing corporate governance can be well understood only if we can appreciate the size of the banking system. We need to appreciate that the Indian banking system has made commendable progress in extending its geographical spread and functional reach.

As per the RBI report the number of scheduled commercial banks functioning in India as on March 31st 2012 was 169, of which 82 were regional rural banks. There are 101261 banks offices spread across the country, of which 36% are located in rural areas, 26% in semi urban areas, 20% in urban areas and the rest 19% in the metropolitan areas. The major bank groups (as defined by RBI) functioning during the reference period of the report are State Bank of India and its associate banks, Nationalised Banks and the IDBI ltd., Old Private Sector Banks, New Private Sector Banks and Foreign Banks.

Evolution of Corporate Governance in Banking System: As prelude to institutionalize Corporate Governance in banks, an Advisory Group on Corporate Governance was formed under the chairmanship of Dr. R. H. Patil. Following its recommendations in March 2001 another Consultative group was constituted in November 2001 under the Chairmanship of Dr. A. S. Ganguly, with a view to strengthen the internal supervisory role of the Boards in banks in India. This move was further reinforced by certain observations of the Advisory group on Banking Supervision under the Chairmanship of Shri M.S. Verma which submitted its report in January 2003. Keeping all these recommendations in view and the cross country experience, the Reserve Bank initiated several measures to strengthen the corporate governance in the Indian Banking Sector. The noteworthy minimum benchmarks noted by the Group relate to the following.

- Strategies and techniques basic to sound corporate governance
- Organizational structure to ensure oversight by board of directors and individuals not involved in day to day running of business
- Ensuring that the direct lines of supervision of different business areas are different
- Ensuring independent risk management and audit functions
- Ensuring an environment supportive of sound corporate governance
- Role of supervisors

The issue pertaining to corporate governance becomes more critical on case of the banks whose controlling power is linked with Government. Government ownership is one of the primary issue that can have a direct impact on the quality of corporate governance. In India almost 80% of the banking operations are under the control of the public sector banks consisting of the nationalised banks, the State Bank of India and its subsidiaries. In Public sector banks, the right of the private shareholders are considerably curtailed as their approval is not required for paying dividend or formalizing the annual accounts.

The importance of corporate governance issues in public sector banks is important due to two principal reasons:

- Firstly, they constitute a huge share of business in the banking industry in India
- Secondly, it is highly unlikely that they are going to be phased out in due course.

Though the general principle of corporate governance is valid for the public sector entities, but they simply cannot imitate the private sector banks in this respect. Things start getting worse, when uncertainties looms involving ownership issues, and the public ownership being treated as a transitional phenomenon. Further, expectation of change in ownership (dilution of Government Stake) can result in the change of institutional structure of significance difference. When Government is the owner, it is accountable to the political institutions, which in turn may not have pure economic motives in mind. A mixed ownership structure can bring the different objectives of shareholding on a common platform and help in reconciling them. Issues relating to the separation of ownership and management in both private and public sectors banks needs to be addressed, in contrast to the traditional Corporate Governance issues stemming from the outside financial, in developing countries and especially in India, things are a bit different. Here, the grueling question is not how the outside financiers (shareholders) exert management control, but also as to how they can (including minority shareholders) exercise control over the big inside shareholders

The most important development in the field of corporate governance and investor protection in India has been the establishment of the securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. The Basel committee in the year 1999 had brought out certain important principles on corporate governance for banking organisations which more or less have been adopted in India. Today the banks are governed by the Banking Regulation Act, 1949; Reserve Bank of India Act, 1934; Foreign Exchange Management Act, 1999; Payment and Settlement Systems Act, 2007; other relevant Statutes and the Directives, Prudential regulations and other Guidelines/ Instructions issued by RBI and other regulators from time to time, including the regulations of SEBI regarding public issues and other guidelines applicable to listed banking though there is scope for enhancing effective implementation.

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

The importance of banks to national economies is underscored by the fact that banking is, almost universally, a regulated industry and that banks have access to government safety nets. In order to meet the statutory need of having sound Capital Adequacy requirements, banks are accessing the Capital Market at regular intervals. Hence the banks need to stimulate the interest of investors at all times. Investors believe that a bank with good governance will provide them a safe place for investment and also give netter returns. Good corporate governance is therefore an important factor in a competitive environment. Investors, customers, employees and vendors have all become more discerning and are demanding greater transparency and fairness in all dealings. To attract and retain the commitment of investors, customers, employees, Banks should ensure that they match the global benchmark in Corporate Governance Practices.

Banks are also important catalysts for economic reforms, including corporate governance practices. Because of the systemic function of banks, the incorporation of corporate governance practices in the assessment of credit risks pertaining to lending process will encourage the corporate sector in turn to improve their internal corporate governance practices, importance of implementing modern corporate governance standards is conditioned by the global tendency to consolidation in the banking sector and a need in further capitalization. It is of crucial importance therefore that have strong corporate governance practices.

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

Among other features, the most important one is the fact that banks form an integral part of the economy of the country, and any failure in a bank might have a direct bearing on the financial health of the country. Banks, help in channelizing the people’s saving.

The capital structure of bank is unique in two ways. First, banks tend to have very little equity relative to other firms. Second, banks’ liabilities are largely in the form of deposits, which are available to creditors/depositors on demand, while their assets often take the form of loans that have longer maturities. Thus, the principle attribute that makes banks as financial intermediaries “special” is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy. The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run.

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

The third important element in the Corporate Governance structure relates to the control function. It is imperative to discuss the same in brief. Control functions in banks deal with internal frauds as well as external frauds. The former relates to situations where the banks own personnel indulge in corrupt and unethical practices. The latter deals with situations where the customers of the bank try to seek for malpractices. The incidents of the external frauds are so devastating that special attention is being mandated both for their prevention as well as their post scenario analysis. In this connection it is important to remind of the COSO framework that was framed with this intention in mind.

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

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

- Pillar 1 – Minimum Capital Requirements
- Pillar 2 – Supervisory Review Process
- Pillar 3 – Market Discipline

Enhancing Corporate Governance in Banks

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

Importance of Corporate Governance for Banks

From a banking industry perspective, corporate governance involves the manner in which their boards of directors and senior management govern the business and affairs of individual banks, affecting how banks set their corporate objectives, run day-to-day operations, consider the interests of various stakeholders, align corporate activities 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.

Sound Corporate Governance Practices for Banks

According to the paper some of the best corporate governance practices for banks include establishing strategic objectives and a set of corporate values communicated throughout the organization, strong risk management functions, special monitoring of risk exposures, setting and enforcing clear lines of responsibility, etc.

Role of RBI in Promoting Corporate Governance: The growing competitiveness and interdependence between banks and financial institutions in local and foreign markets have increased the importance of corporate governance and its application in the banking sector. Corporate governance in banks can be achieved through a set legal, accounting, financial and economic rules and regulations. To make sure that the competence and integrity in banking sector is maintained, the need for uniform standards of the concept of governance in private and public sector is emphasized. The regulatory framework implemented by the central bank can affect the overall well being of banking sector.

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

Important commandments for ensuring corporate governance in banks are:

- Banks shall realize that the times are changing
- Banks shall establish an Effective, Capable and Reliable Board of Directors
- Banks shall establish a Corporate Code of Ethics for themselves
- Banks shall consider establishing an office of the Chairman of the Board
- Banks shall have an effective and Operating Audit Committee, Compensation Committee and Nominating/ Corporate Governance Committee
- Banks shall consider Effective Board Compensation
- Banks shall disclose the information
- Banks shall recognize that duty is to establish Corporate Governance Procedures that will serve to enhance shareholder value

Recent Scenario

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

- Introduction of non-executive members on the Board
- Constitution of various Committees like Management Committee, Audit Committee, Investor's Grievances Committee, ALM Committee etc.
- Gradual implementation of prudential norms as prescribed by RBI
- Introduction of Citizens Charter in Banks

- Implementation of "Know Your customer" (KYC) concept.

Summing Up: Banks and financial sector being a highly service oriented sector, making corporate governance effective is a great challenge. More so, when the driving force of commercial banks is to grab the opportunity, trading profits with only focus on profitability. The levers of systemic control have to be not only progressively tightened but they are also to be scrutinized from the point of deliverables. Moreover the recent global financial crisis leading to the demise of several reputed global investment banks exposes the fissure in the effectiveness of corporate governance model.

Banking sector is the key for monetary conditions in a country. Due to the special nature of the activities carried on by the banks, they face a lot of problems as far as the area of corporate governance is concerned. In the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. The guidance paper issued by the Basel Committee is of paramount significance in enforcing corporate governance standards in various countries across the world.

Corporate Governance is now identified and acknowledged as a powerful tool to generate trust and confidence in an institution. The trend in the world of targeting governance practices in the banking sector to be at the cutting edge of prevailing practices worldwide is a significant step in the right direction and should continue to be so in the future as well.

India has one of the best Corporate Governance legal regimes but poor implementation. SEBI has carved out a certain more stringent provisions relating to listed companies as a condition of the Listing Agreement.

The special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels. Due to special nature of the activities carried on by the banks, they face a lot of problems as far as the area of corporate governance is concerned. Also, in the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. There exists a doubt as to what standard should be applied while enforcing corporate governance in banks. Central banks play an important role in this regard. As far as best corporate governance practices for banks are concerned, they may include realization that the times are changing, establishing an effective, capable and reliable board of directors, establishing a corporate code of ethics by the banks for themselves, considering establishing an office of the chairman of the board, having an effective and operating audit committee, compensation committee and nominating/ corporate governance committee in place, considering effective board compensation, disclosing the information and recognizing their duty to establish corporate governance procedures that will serve to enhance shareholder value.

Conclusion

This study concluded that, the corporate governance practices in the banking and financial sector in India should improve for best investment policies, appropriate internal control systems, better credit risk management, better customer service and adequate automation in order to achieve excellence, transparency and maximization of stakeholder' value and wealth.

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