Toward Effective Governance of Indian Banking Sector through Corporate Governance

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Abstract

Corporate Governance has emerged as a benchmark for judging corporate excellence in the context of national and international business practices. It is a dynamic concept, in terms of scope, thrust and relevance. The issue is particularly important for developing countries since it is central to financial and economic development. Corporate Governance covers a variety of aspects such as protection of shareholders' rights, enhancing the shareholders' value, issues concerning the composition & role of the Board of Directors, deciding the disclosure requirements, prescribing the accounting systems, putting in place effective monitoring mechanism, etc. In Banking Parlance, the Corporate Governance refers to conducting the affairs of a banking organisation in such a manner that it gives a fair deal to all the stakeholders i.e. shareholders, bank customers, regulatory authority, society at large, employees etc. There is a no. of parameters based on which the level of Corporate Governance can be judged for a banking organisation such as: - the suggested model code for best practices, preferred internal system, etc. Banks form a crucial link in a country's financial system and their well-being is imperative for the economy. The significant transformation of the banking industry in India is evident from the changes that have occurred in the financial markets, institutions and products. Banks play a very kingpin role in the financial & economic system of a developing country; its failure owing to unethical or incompetent management action poses a threat not just to the shareholders but to the depositing public and the economy at large. The level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities are the two stellar features that set banks apart from other business. The policy makers, which comprises of the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. RBI has already taken a no. of steps during the recent years to enhance the usefulness of good corporate governance. However, there is a lot, which the banks themselves have to do, since adherence to prudential norms is the minimum level of compliance & banks have to achieve higher standards for good governance. The success of Corporate Governance lies in minimising the regulatory norms & adoption of voluntary codes. In this article, the nature and purpose of corporate governance has been discussed with special emphasis on the problems of banks in the field of corporate governance. Also, the conflicts in case of Indian scenario have also been described. Moreover, the report by the Basel Committee has been explained and how is helps in the corporate governance in banks. And the best practices regarding corporate governance in banks have also been illustrated. This article describes the practices of corporate governance attributes in banking sector and how they adhere to corporate governance practices. Both private and public sector banks are adhering to mandatory requirements of corporate governance attributes as a result it is bringing more transparency and minimizing the chances of fraud and malpractices. However, hope is looming large for the proper implementation of corporate governance principles in Indian Banking Sector

Keywords: Corporate Governance, Basel Committee, Private and Public Sector Banks, Indian Banking Sector

Introduction

The interest in the Corporate Governance practices of modern corporations, particularly in relation to accountability, increased following the High-Profile Collapses of a no. of large corporations during 2001-2002. Corporate Scandals of various forms have maintained public & political interest in the regulation of Corporate Governance. Some of the High-Profile Companies include: - **Enron**, **WorldCom**, **HIH insurance group** etc. These failures have shattered the trust of investors worldwide.

Some Scandals have made headlines all around the world were somewhere related to the poor Corporate Governance. These include the $18 billion meltdown of **Parmalat Finanziaria, SpA in 2003**. Parmalat was among the largest food-based companies in the world .The Parmalat case was one of the biggest scandals to hit Europe and many analysts called this fraud as '**Europe's Enron**'. The company's corporate governance structure could not keep up to some of the key existing Italian corporate governance standards of best practice (Melis, 2004).Another classic example of a corporate house collapsing due to poor decision making and weak corporate governance was the **HIH insurance group of Australia**. This collapse resulted in a deficiency up to $5.3 billion, "making it the largest corporate failure" in Australia (Lipton, 2003). The collapse of the **China Aviation Oil (CAO)** also created certain doubts regarding the standard of corporate governance in China. This collapse came at a time when many companies were trying to get internationally listed and foreign investors were becoming more and more eager to buy them out (Economist Intelligence Unit, 2004).

Because of the country's unique geographic, social, and economic characteristics the Indian Banking systems is significantly different from that of other Asian nations. India has followed the path of **"growth-led exports"** rather than the **"export-led growth"** of other Asian economies, with emphasis on self-reliance through import substitution.

Corporate Governance covers a variety of aspects such as protection of shareholders' rights, enhancing the shareholders' value, issues concerning the composition & role of the Board of Directors, deciding the disclosure requirements, prescribing the accounting systems, putting in place effective monitoring mechanism, etc. In Banking Parlance, the Corporate Governance is all about conducting the affairs of a banking organisation in such a manner that it gives a fair deal to all the stakeholders i.e. shareholders, bank customers, regulatory authority, society at large, employees etc. The level of Corporate Governance can be judged for a banking organisation on number of Parameters such as: - the suggested model code for best practices, preferred internal system, etc. 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. No doubt, banks are different from other corporate in important respects, and that makes corporate governance of banks not only different but also more critical. Banks lubricate the wheels of the real economy, are the conduits of monetary policy transmission and constitute the economy's payment and settlement system. By the very nature of their business, banks are highly leveraged. They accept large amounts of uncollateralized public funds as deposits in a fiduciary capacity and further leverage those funds through credit creation. The presence of a large and dispersed base of depositors in the stakeholders group sets banks apart from other corporate. Banks are interconnected in diverse, complex and oftentimes opaque ways underscoring their 'contagion' potential. If a corporate fails, the fallout can be restricted to the stakeholders. If a bank fails, the impact can spread rapidly through to other banks with potentially serious consequences for the entire financial system and the macro-economy. On top of that, banks escape some of the disciplinary pressures of the market, as their balance sheets are typically opaque. Given the centrality of banks to modern financial systems and the macro-economy, the larger ones become systemically important. Poor Corporate Governance is not a new subject in the Banking Industry. Rather this inefficiency has been around for a very long time. Since the beginning of banking in Nigeria in 1914 almost "75 banks were lost primarily because of factors related to poor corporate governance". The banks did not fail due to lack of customers but due to how they were managed and governed. According to a study by the Nigerian Deposit Insurance Corporation, the main reason for these failures was interference of board members (www.allafrica.com). Moreover, the recent subprime crises highlighted many issues of corporate governance in banks world over. The main issue was that of independent directors. For e.g., UBS, one of the world's largest banks was among the biggest losers in the subprime crisis. It suffered a loss of about $38 billion. As a result it replaced four of its directors. The departing members included "three outsiders with experience respectively in rail equipment, chemicals and information technology". This shows that banks should definitely use experts on their boards (Economic Times, 2008).

Corporate Governance (CG) can be viewed from two different angles. One being transparency in the corporate functioning thus protecting the investors interest (reference to agency problem), and the other being concerned with having a sound risk management system in place (special reference to

banks). At its most basic level, corporate governance sets up the “rules of the game” to deal with issues arising from separation of ownership and management so that the interests of all stakeholders are protected. It has been seen that businesses with superior governance practices generate bigger profits, higher returns on equity and larger dividend yields. Conversely, the failure of high profile companies such as BCCI, Enron, WorldCom and Parmalat was a clear lesson of the damage bad corporate governance can inflict. Here at home we had a corporate scandal of unprecedented dimensions in Satyam Computers where the company’s CEO admitted to having falsified accounts to the tune of over ` 7000 crore, and that too spread over several years.

The boards and senior managements of banks have to be sensitive to the interests of the depositors. The Institute of International Finance, an association of major international banks, has concluded after an examination of board performance of banks in 2008 that, “events have raised questions about the ability of certain boards to properly oversee senior managements and to understand and monitor the business itself”. According to the Organisation for Economic Co-operation and Development (OECD) report, nearly all of the 11 major banks reviewed by the Senior Supervisors Group (an informal group of senior supervisors under the auspice of the Financial Stability Board - FSB) in 2008 failed to anticipate fully the severity and nature of the market stress. On the positive side, there is some early evidence that banks with stronger corporate governance mechanisms moderated the adverse impact of the crisis on them, had higher profitability in 2008 and provided substantially higher stock returns in the immediate aftermath of the market turmoil. In emerging economies, banks are more than mere agents of financial intermediation; they carry the additional responsibility of leading financial sector development and of driving the government’s social agenda. The OECD set out its corporate governance principles in 1999 but revised them in 2004. Basel Committee on Banking Supervision (under the aegis of the BIS) published guidelines on corporate governance in banks in 1999. As an update, in July 2005, the Basel Committee has issued a Consultative Document on enhancing corporate governance for banking organisations, seeking comments by end October 2005. Therefore, the corporate governance should be viewed as an ongoing process subject to rapid changes based on experiences, developments and policy setting.

Corporate Governance is very much crucial for structuring capital allocation for both the factory level and firm level in case of Banks & other Financial Institutions. The Banks assume a central & pivotal role as they form an integral part of the economy. There would be more possibility of effective capital allocation and proper implementation of Corporate Governance over the firms if there are effective governance mechanisms. There is a special reason of viewing Corporate Governance in banks in isolation. Crises and failure of banks has crippled several economies, shaken Government and resulted in economic turmoil. When the bank insiders exploit the bank for their own cause, there is an increased likelihood of bank failure, that can curtail overall economic development.

Need of Corporate Governance in Banking

From the Banking point of View , Corporate Governance involves the manner in which the business and affairs of individual institutions are governed by their Board of Directors (BODs) and Senior Management, affecting how banks do the following: Setting Corporate Objectives (including generating economic returns to the owners), Running the day-to-day operations of the business, Considers the interests of recognized stakeholders, Aligning the corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, & in compliance with the applicable laws and regulations and lastly, protecting the interests of the depositors. As most of the banks are owned by government in developing countries, so they are mostly guided by government bodies and many laws based on stereotype procedures. 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. 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. Ownership pattern, regulatory environment, societal pressure (on the developmental role of banks) and the broad structure would be the key elements 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 ability of our banks (Public sector) to compete

effectively in the current market situation (Ravisankar, 1999). Banks and financial institutions have been making pivotal contributions over the years to nation's economic growth and development.

Literature Review

The term "Corporate Governance" which was rarely encountered before the 1990s has now become an all-pervasive term in the recent decade. In today's scenario this term has become one of the most crucial and important concepts in the management 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". At a first glance, Corporate Governance issues do not appear to be related to banking reforms. However, typical challenges faced by banks in transition economics have given way towards focused attention to the study of banking reforms.

In their work, **Berle and Means (1932)**, advocates that the diffused shareholders influences corporate governance through voting rights and the election of the Boards of Directors and the diffused debt holders put constraints on managerial discretion through bond covenants. It is a common observation that the small investors do not enjoy exercising corporate governance primarily due to information asymmetries and poorly developed legal and regulatory mechanisms.

Study conducted by **Berle and Means (1932)**, shows that diffuse shareholders are in a position to exert corporate governance by directly voting on crucial issues and indirectly by electing the Board of Directors that represents the interests of owners. But existence of large information asymmetries between the managers and the small shareholders deters the diffuse shareholders from effectively exerting corporate control. One of the way by which managers can be prevented from deviating too far from looking after the owners is to have concentrated ownership. Large investors find it worthwhile in acquiring information and monitor managers. As a result of the large investments made, the large (concentrated) debt holders are more likely to possess the capacity to exercise control over the firm by keeping a strict watch on the managers and thus influencing the composition of the Board of Directors.

As pointed out by **Myers (1977)**, it may also happen that large creditors may induce the organization to sacrifice good investments and lake on too little risk since the creditors bears some of the cost but will not be ready to share the benefit.

Reference of such work is evident in the work of **Pohl and Claessens (1994)**, examining the banking structure in the European markets. The standard Agency Theory Conceptualize corporate Governance problem in the way how the equity holders and debt holders influence managers (agents) to act in the best interest of those who provided capital to the company.

In the classic study conducted by **Shleifer and Vishny (1997)**, it was evident that small investors have limited role in exerting corporate control (for countries other than US and UK).

As pointed out by **Ross Levine**, Banks are comparatively more opaque than non-financial firms are. As an outcome of their opacity, the issues relating to agency theory is predominant with banks as pointed out by **Furfine (2001)**.In banks, the quality of loan is not readily tracked resulting in accumulation of NPL. This is coupled with the fact, that it is all the easier for banks to alter the risk composition of their assets as compared to non-financial firms. The other issue pointed out by **Ross**, that makes the study of Corporate Governance in banks unique, is the stringent regulations under which banks have to operate. The study becomes more interesting for Government owned banks. When Government itself is the owner, it changes total complexion of governance of banks. The controlled hand of the Government regulation and ownership of banks calls for an independent discussion of Governance in banks.

In a much wider term, 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" **(Parekh, 2003)**.

In the study conduction **(Barth, Caprio and Levine, 2003)**, it is pointed out the 41 countries (out of 107) has a single entity that is less than 50% and 38% limits less than 20%.

The basic tenets of Corporate Governance stems from the concepts of control and accountability. The empowered Board of Directors in poised between the shareholders or the owners of the organization on one hand and, executives, managers as well as employees on the other. Thus, it is obvious to say that Corporate Governance deals with both power and accountability. The works by Berle and Means can be said to have triggered the federal legislation that later lead to the creation of the Securities and Exchange Commission in the United States.

Several research papers have pointed out, that though the finding of **Berle and Means**, may not hold good across geographies for all the time, the **agency theory** can be viewed as a common phenomenon of the development of the economy and particularly its capital markets. The roots of modern theory of corporate Governance were probably sown by the famous (infamous) Watergate Scandal in the United States. The unveiling of this episode led to the development of the **Foreign and Corrupt practices Act of 1977** in the US that spoke about specific provisions pertaining to the establishment, maintenance and review of systems of internal control. In 1979, the securities exchange commission of US drafted the proposals for compulsory reporting of internal financial controls. Among the various reports that were published by the regulatory bodies, notable were the **Treadway Report**, (**leading to the Development of the COSO model**), **Blue Ribbon report** on corporate directors and **audit committee effectiveness**, and **public oversight Board panel's report**. The **COSO (Committee of Sponsoring Organization)** came into existence in **1992** that was subsequently refined by other UK reports, prominent among them being.

The **Cadbury Committee Report** chaired under the able guidance of **Sir Adrian Cadbury**, was set in **May, 1991**; and was published in **1992**. This later on became the benchmark for code of best practices. After the success of the Cadbury Committee Report, there have been a lot of variations in the same. The **Paul Ruthman committee** spoke on the practical applicability of the Cadbury Committee recommendations. Further modifications were brought in by **Ron Hampel in the combined code**. Subsequent developments were initiated in the **Turnbull guidance report in September, 1999**. During all this time, one common observation was pointed out. It was seen that, one common reason for the failure of all the Corporate Governance regulations was primarily **lack on an effective risk management**. Having identified the lacunae, the **Basel norms** were initiated that now needs to be implemented.

The Indian scenario

Evolution of corporate governance of banks in India

In the pre-reform era, there were very few regulatory guidelines covering corporate governance of banks. This was reflective of the dominance of public sector banks and relatively few private banks. That scenario changed after the reforms in 1991 when public sector banks saw a dilution of government shareholding and a larger number of private sector banks came on the scene. ***These changes shaped the post-reform standards of corporate governance in the following ways:***

1. ***First***, the competition brought in by the entry of new private sector banks and their growing market share forced banks across board to pay greater attention to customer service. As customers were now able to vote with their feet, the quality of customer service became an important variable in protecting, and then increasing, market share.
2. ***Second***, post-reform, banking regulation shifted from being prescriptive to being prudential. This implied a shift in balance away from regulation and towards corporate governance. Banks now had greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. The boards of banks had to assume the primary responsibility for overseeing this. This required directors to be more knowledgeable and aware and also exercise informed judgement on the various strategy and policy choices.
3. ***Third***, two reform measures pertaining to public sector banks - entry of institutional and retail shareholders and listing on stock exchanges - brought about marked changes in their corporate governance standards. Directors representing private shareholders brought new perspectives to board deliberations, and the interests of private shareholders began to have an impact on strategic decisions. On top of this, the listing requirements of SEBI enhanced the standards of disclosure and transparency.

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

5. ***Lastly***, the 'structural' reform measures included mandating a higher proportion of independent directors on the boards; inducting board members with diverse sets of skills and expertise; and setting up of board committees for key functions like risk management, compensation, investor grievances redressed and nomination of directors. Structural reforms were furthered by the implementation of the Ganguly Committee recommendations relating to the role and responsibilities of the boards of directors, training facilities for directors, and most importantly, application of 'fit and proper' norms for directors.

Reserve Bank's Approach towards Corporate Governance

The formal policy announcement in regard to corporate governance was first made by **Dr. Bimal Jalan in the Mid-Term Review of the Monetary and Credit Policy on October 21, 2001**. Pursuant to this announcement, a **Consultative Group was constituted in November 2001 under the Chairmanship of Dr. A.S. Ganguly**, with a view to strengthen the internal supervisory role of the Boards.

An **Advisory Group on Corporate Governance** under the chairmanship of **Dr. R.H. Patil** had earlier submitted its report in March 2001 which examined the issues relating to corporate governance in banks in India including the public sector banks and made recommendations to bring the governance standards in India on par with the best international standards.

There were also some relevant observations by **the Advisory Group on Banking Supervision under the chairmanship, Shri M.S. Verma which submitted its report in January 2003.**

Keeping all these recommendations in view and the cross-country experience, the Reserve Bank initiated several measures to strengthen the corporate governance in the Indian banking sector.

In June 2002, the report of the Ganguly Group was transmitted to all the banks for their consideration while simultaneously transmitting it to the Government of India for appropriate consideration.

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

As a step towards distancing the regulator from the functioning of the Boards***, the Reserve Bank has withdrawn its nominee directors from almost all the private sector banks.*** Observers have been appointed as transitional measures mostly in respect of those banks, which are yet to fully comply with the Reserve Bank's guidelines of ownership of governance. It is hoped that the need for observers also will diminish as the quality of governance improves. ***Second***, legislative amendments have been proposed in regard to the public sector banks to remove the provisions for mandatory nomination of RBI officers on their boards and thus, to bring them on par with the private sector banks in this regard. ***Third***, the Government has been requested to keep in view the policy framework for governance in private sector banks while deciding on the appointments of the directors on the Boards' of public sector banks and constitution of various committees of the Board. ***Fourth***, the RBI, as far as possible, has recently been refraining from issuing circulars or instructions specifically addressed to the public sector banks. It is expected that all the existing instructions specifically applicable to the public sector banks will be reviewed by the Reserve Bank so that uniformity in regulatory framework between different categories of banks is formally established. ***Fifth***, several amendments to the Banking Regulation Act have been proposed which would enhance RBI's capacity to ensure sound governance especially relevant to the banks, consistent with global best practices.

Regulation and Corporate Governance of Banks

1. Banks forms 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 that acts as a multiplier on driving the economy forward.
2. 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.
3. Moreover, Corporate Governance structure relates to the control function. 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.

Issues Related To Corporate Governance of Banks in India

A. Bank Ownership

The first type of issue is concerned about Ownership. There is typically a divergence between the interests of shareholders and of depositors. Shareholders want profits to be maximized by taking on greater risk; depositors have an overriding preference for the safety of their deposits and hence for lower risk. At the same time, depositors have little say in the governance of banks whereas the shareholders' say is very pronounced. Within the shareholder group, the extent of control exercised by promoter shareholders too is an important determinant of the effectiveness of corporate governance. Another way to look at the issue of ownership is in terms of public vs. private ownership. If banks are publicly owned, issues of conflict of interest between shareholders and depositors get mitigated. Public ownership of banks would also inspire confidence in the financial system. On the other hand, an important question is whether effective and autonomous corporate governance is compatible with public ownership of banks. Diversified ownership and 'fit and proper' status of shareholders are other important determinants of corporate governance. The Reserve Bank's guidelines on ownership and governance in private sector banks, issued in February 2005, were aimed at ensuring that ownership and control of banks are well diversified.

B. Accountability, Transparency & Ethics

The separation of ownership and management can create conflict of interest if there is a breach of trust by managers on account of intention, omission, negligence or incompetence. This can be taken care of by making boards more accountable to all stakeholders and making their functioning transparent.

C. Compensation

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

D. Splitting The Posts Of Chairman & C.E.O Of Banks

Splitting the posts of the Chairman and the CEO of banks is another issue that has generated a contentious debate. The Ganguly Committee appointed by the Reserve Bank had recommended that the posts of the chairman of the board and the CEO of the bank should be bifurcated.

The logic is that such a bifurcation of leadership of the board from the day to day running of the business will bring about more focus and vision as also the necessary thrust to the functioning of the top management of the bank. It will also provide effective checks and balances.

E. Corporate Governance Under Financial Holding Company Structure

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

Ensuring high standards of corporate governance:

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***

1. **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.
2. **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 .
3. **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.

Best Practices of Corporate Governance in Banks

Good governance can be built based on the business practices adopted by the board of directors and management. ***Important commandments for ensuring corporate governance in banks are:***

A. Banks shall realize that the times are changing: The issue of corporate governance has gained attention only in the recent times. Therefore, even the smallest banks need to focus on corporate governance restructuring. This is due to the apparent lack of integrity and values in operation of some large corporations.

B. Banks shall establish an Effective, Capable and Reliable Board of Directors: Establishing an effective, capable and reliable board of directors requires involving well qualified and successful individuals with integrity. This implies that a majority of banks' board of directors should be truly independent directors. The board must be effective and must meet periodically and it should have long-term policy, strategy and values.

C. Banks shall establish a Corporate Code of Ethics for themselves: Corporate ethics and values should be established at the top and should be used to govern the operations of the bank both from long-term and short-term point of view. These codes should be reviewed annually. Unless this exercise is accomplished, executive management cannot anticipate that the rank and file employees will follow such a code on their own.

D. Banks shall consider establishing an office of the Chairman of the Board: Such an office will be made to report to the board and will act as the board's eyes and ears on a daily basis in connection with the functions of the bank.

E. Banks shall have an effective and Operating Audit Committee, Compensation Committee and Nominating/Corporate Governance Committee: The audit committee, compensation committee and nominating committee should be composed of all independent, outside directors of the bank who operate independently. These committees should have access to attorneys and consultants paid for by the bank. This independence of committee will ensure against any bias in the internal audit committee's decisions.

F. Banks shall consider Effective Board Compensation: Fair compensation should be paid to the directors. Their remuneration should be commensurate to with the risks they take.

G. Banks shall disclose the information: Bank will find that the disclosure will be quicker and more burdensome than it was in the past. This may be through quarterly letters to the shareholders or other types of communication.

H. Banks shall recognize that duty is to establish Corporate Governance Procedures that will serve to enhance shareholder value: The primary objective of the board of directors is to maximize the shareholders' wealth. The strategy adopted to achieve this objective should now encompass corporate governance procedures and should be designed with long-term value for shareholders in focus.

Conclusion

The Reserve Bank is continuously striving to ensure compliance with international standards and best practices of corporate governance in banks as relevant to India.RBI is also interacting closely with the Government and the SEBI in this regard. Increasing regulatory comfort in regard to standards of governance in banks gives greater confidence to shift from external regulation to internal systems of controls and risk-management. 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. The success of corporate governance rests on the awareness on the part of the banks of their own responsibilities.

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