Corporate Governance Practices in Indian Banks

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In India, Corporate Governance as a topic has moved from academic and arcane journals, to the business pages – and occasionally even front pages of newspapers. While good governance policies are important for all companies, they have a more significant impact on banks, given the systemic importance of banking to the economy. In this article I will focus on Corporate Governance in the financial system – more particularly as it is practiced by Indian Banks. Although overall corporate governance ("CG") in Indian banks has improved steadily, there is room for further improvement.

It is useful to define corporate governance, and rather than use a text book definition, the term here is broadly used, to include the systems and processes a company has in place to oversee its affairs that are essential not only for its own wellbeing, but also those of its shareholders and creditors. The need to safeguard the depositors funds is an added dimension with regard to banks as effective corporate governance are essential for maintaining public's confidence in the banking sector and the economy as a whole. Supervisors understandably, are focusing more on governance now than in the past. And although their recommendations, structures and systems vary across entities and geographies, invariably the responsibilities begin (-and end) in the boardroom. The starting point is invariably the Board. Today banks face an increasing array of complex risks – credit, liquidity, concentration, market (- both interest and currency), settlement and operational. The board members need to be qualified, understand their oversight role, including the banks risk profile, without being intrusive. The board members need to understand the banks strategic objectives and resolve issues relating to conflict of interest – particularly where a bank is both a principal and an agent, in a manner that will not compromise the bank. The internal and external audit needs to be rigorous and disclosures timely, accurate and meaningful. The Board needs to ensure that the bank is run on sound business principals, and its members understand the regulatory environment. Finally the members need to ensure that they are able to commit sufficient time to their role.

In India here have been a number of initiatives to help advance governance and disclosure practices by Indian banks during the last few years, with the Reserve Bank of India, India's central bank, focusing on the way CG affects: a) the role of the supervisor, i.e. the quality of oversight, and b) the interests of depositors, in terms of transparency, off-site surveillance and prompt corrective action. Over the past two years, it has created a number of committees to look into aspects of CG in banks and benchmark international best practices for implementation. More recently, it has been looking at harmonizing the approach suggested by the Securities and Exchange Board of India, India's Securities Commission and its own recommendations.

There are 28 state-owned banks operating in India, accounting for 79% of the assets of the commercial banking system. Government ownership in these banks varies between 51% and 100%. Over the last few years, intervention by the state in credit decisions has weakened – direct intervention in individual credit decisions is being replaced by lending policies aimed at achieving the broader social objectives of the government in power. There has also been an improvement in the practices of these banks with regards to disclosure, driven to a large extent by these banks listing their equity on the domestic bourses, and complying with disclosure and guidelines stipulated by the stock exchanges. The state-owned banks have also been investing in technology which is helping to set decision-taking boundaries. The diverse mix of shareholders and frequent interaction with large institutional investors has maintained pressure on these banks to adopt more progressive CG standards. However, their boards, including each bank's executive chairman and independent directors, continue to be nominated by the government. Power is concentrated in the executive chairman, who is generally appointed on account of seniority. Given this ownership overhang, each bank's board is unable to fulfill its fiduciary responsibilities to evaluate the bank's strategy and operations critically and objectively. It also makes it difficult for these banks to ensure that they employ effective management teams to pursue reasonable financial objectives and promote an environment of proper corporate conduct. Government ownership also implies that a bank's various stakeholders can take comfort that their money is safe: this creates a potential "moral hazard" as banks can take a risky position without facing higher costs on deposits. It could also make depositors, debt-holders and equity holders less inclined to monitor these banks closely, and makes the task of differentiating across banks on the basis of CG more challenging. This area needs to be addressed as a priority.

Governance standards are highest among the new private sector banks, but this has not always been so. Incidents at Global Trust Bank and Centurion Bank in the early 2000s, to name just two well publicized events, highlight the result of poor governance and raised issues with regard to board independence and related party transactions. Today, the situation is very different for the private banks. Two of these – HDFC Bank and ICICI Bank – are listed on the New York Stock Exchange; consequently, these banks are Sarbanes Oxley-compliant, adhering to the CG practices and disclosures expected by investors in the US market. UTI Bank is listed on the London Stock Exchange and more recently, Centurion Bank of Punjab, under new management, has obtained an overseas listing. This has had a demonstrable effect on banks in general. The boards of these banks are engaged in discussions regarding strategy and performance benchmarking. The discussions are reasonably broad-based, with independent directors (covering a wide range of experience) and the various board committees (compliance, audit, risk, compensation, etc.) all reasonably vocal. In marked contrast, the old private sector banks have weak levels of CG. These banks are controlled by a few families or by communities which invariably have had business interests aside from the bank. While these banks might have independent directors and various board committees, these tend to be passive, with decision-making concentrated in the large shareholders, which increases the chance of related party lending. These banks, too, need to address their governance practices as a matter of urgency.

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