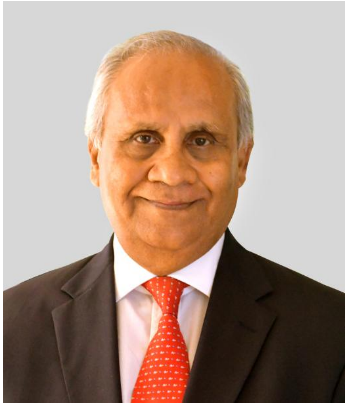
Public Sector Banking: Building the Road to Effective Governance



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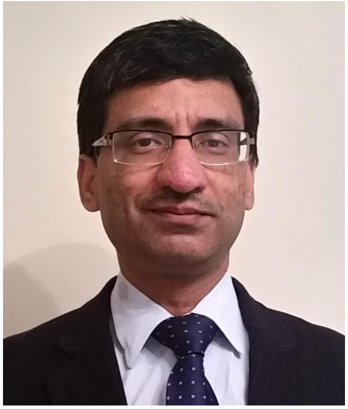

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One of the main challenges in the post Covid-19 economic revival will be to ensure that banking sector performs smoothly and efficiently without any failures. The role of governance will be crucial in this respect. Governance is increasingly and rightly moving towards the centre-stage of banking sector reforms for various reasons. The growing performance (and NPA) issues and events at YES bank call for a better governance. In the recent past, some public banks have been amalgamated into four big banks, and this provides yet another reason to build strong governance frameworks. By definition, big banks have a high impact – both good and bad - on the economic functioning, and strong governance is a lever to ensure that this impact is largely beneficial. Internationally, effective governance has been at the centre stage of banking reform process since the financial crises of 2008, and various international bodies, such as Financial Stability Board (FSB) and Group of 30 (G30) along with regulators from various countries have provided leadership in this direction.

Building the road to effective banking governance requires that we take an integrated view of the sector and also recognize the hard truth that strong governance will require transformational change as well as deep and lasting commitment.

1.0 Banking Sector the Context and Issues

In India, 70% of the banking is done by the Public Sector Banking (PSB), which has government as its owner. PSB are subject to dual regulation, and sandwiched between governmental and RBI's requirements. It is debatable whether or not Indian banking can rise to its' potential, when 70% of the banking is seriously constrained by the existing governance complexities and challenges.

The need for PSB reform is not an unknown and unchartered territory. Nayak Committee[1] on Governance and Khandelwal Committee[2] on Human Resources (HR) in PSB provided detailed description of the various problems, challenges and gaps that need to be urgently addressed. In 2015, then Finance Minister, Late Mr. Arun Jaitley, announced a seven-pronged Mission Indradhanush and "Gyan Sangam" (a Conclave of PSBs) to bring about banking reforms. In spite of such works and initiatives, governance in PSB remains complex and hardly conducive to good banking performance.

It is said that "Every system is perfectly designed to get the results it gets"[3], and this seems to be especially true for the PSBs. There is a need to bring transformational structural reforms in an integrated way. Mission Indradhanush did have strong points, but it did not go the distance when it came to PSB reform. There is a need to recognize that incremental reforms do not cover the vital parts and will not design the system for the results that the PSB and country needs.

The need for structural PSB reform is needed in various areas, and few main ones are discussed below.

2.0 Dual Regulation

PSBs are subject to dual regulation from the government as well as RBI. The dual regulation not only makes governance complex and constraining, it is also a subject of debate as it leads to uneven playing field between the private and public sector.

Nayak committee recommended that RBI should be the sole regulator, and felt that dual regulation is discriminatory. It outlined the process to achieve this goal including the setting up of Bank Investment Company (BIC). Unfortunately, there has not been any progress on that in the way Nayak Committee recommended.

PSBs frequently get compared to private sector banks on the performance grounds, though they lack the empowerment and governance frameworks of the private sector. There is an additional nuance to the situation here. As M. Damodaran[4], Former Chairman, SEBI, UTI and IDBI, pointed out recently, "The objective of any regulation ought to be the ensuring of level playing field…". He further pointed out that all participants banks, private and public, should be able to compete on equally, "without any undue advantage being conferred on one set of participants, on account of their ownership pattern". Having a single regulator for all banks will enable a level playing field, and also pave the way for consistent governance.

There is also a need to critically assess whether or not the legacy governance requirements are needed in the current changed context. Banking is a fast-moving industry, and governance requirements stipulated in one context many years, if not decades back, may not be useful – or even counter-productive – in today's context.

3.0 Structural Reforms

The governance process cannot be effective until the board is effective. Unfortunately, as Nayak committee noted, it is unclear if the PSB boards have required sense of purpose in strategy and risk management. It also noted the need to make boards empowered. These are crucial observations. An example is, while private sector banks can constitute their own boards, in public sector bank the Board is appointed by the government except for the shareholder representative/s. As a result, the key roles including CEOs and full-time directors sometimes remain vacant for months together. Needless to say, this has a knock-on effect on PSB's governance and performance. There is an urgent need to make structural reforms to improve the board level effectiveness and improve PSB's performance. This will include, but not limited to, the following reforms:

Power to Make Appointments

A crucial reform will involve empowering boards to make appointments. While the mission Indradhanush separated the positions of Chairman and the Managing Director (CEO), it brought about the challenge of filling in CEO position at the right time with the right candidate. With the establishment of BBB (a recommendation of Indradhanush), the delays in the process of appointment of wholetime directors is mostly reduced, but the same cannot be said about the appointment of other directors, which is done by the government. Sometimes bureaucratic delays keep the Boards truncated and the functioning of various committees are hampered. Each PSB – or any other firm for that matter – has a unique leadership context, and only the board is likely to know in a deep way the context and challenges and, importantly, the competencies gaps. If boards have the power to appoint the directors, such issues could be taken care of by appointing directors with appropriate skills and background. They will know, for example, if the bank needs a leader with experience in digitalization, or other areas of banking? This reform to make appointment will also allow boards to proactively plan for succession planning and implement the search process.

This reform will require legislative changes more particularly in the Banking Companies Acquisition and transfer of undertaking Act,1970/1980, which provides scheme of nomination of directors on the Board of a nationalised Bank. This is a fundamental step to improve the governance in PSBs.

CEO/MD Tenure

The second reform that is urgently needed deals with the tenure of CEO/MD in a PSB. RBI's recent discussion paper (June 2020) on improving governance in commercial banking seeks to cap the tenure of majority shareholder/owner of private bank's CEO and WTD to a maximum of 10 years. While this is a right step in the context of private banks, PSB's have opposite problem. The CEO/MD roles have a very short tenure. With the amalgamation of some public sector banks, both the nature of complexity and size of amalgamated banks have gone up. This makes it difficult to implement significant and strategic changes, and assess their impact on banks in a short window of time. A short tenure also gives rise to uncertainty and commitment issues. It is therefore the need of the hour to stipulate a minimum tenure of 4 years to the CEO/MD in a PSB. This will ensure that CEO/MD has the time-window to implement the strategy and changes needed, and the banks benefits from the process.

Other Areas for Governance Reform in PSBs.

There is no shortage of issues calling out for reforms in the Public Sector Banks (PSB). Few additional areas are covered below.

- ☞ Nayak Committee noted the need to make the process for board appointments more professional. An important area that calls out for reform is the process for independent directors. To start with BBB should undertake due diligence on all the nominees except for the RBI and government nominee.
- ☞ It is also a common knowledge that the number of banks did not have senior managers, and that roles in key committees (such as audit committee) go unfilled. The sixty-eight report of the Standing Committee on Finance (2017-18) also expressed concern over the emerging gaps at senior levels. This is an area of significant risk as banking is becoming increasingly complex and specialized function. There is a need to look at the Human Resources risk in an urgent manner, and mandate HR committee with representation on

the board. It is noteworthy that Khandelwal Committee recommended Board's committee on HR, but barring some banks, either banks have not created such committees or they have become moribund. The government should ensure that HR committee of the Boards are activated and an annual Human Capital report is submitted as a part of annual report on the lines of Governance report.

- There is also a need to look at the compensation in PSBs especially of whole-time directors and senior management functionaries. The gap between the private and public sector banks is already significant, and, as banking becomes more specialised and domain expertise-based in the future, this gap could become even more. There is a need to use Employee Stock Options strategically, as recommended in the Nayak Committee report, which will also address to some extent the emerging gap between PSBs and private banking pay levels.
- There is an urgent need to limit the roles and requirements of various board level committees to strategic and significant aspects to ensure focus as well as accountability. This assumes significance in the context of current RBI discussion paper on governance (June 2020). It outlined detailed requirements for audit committee (32 roles), risk Management committee (30 roles), and NRC (20 roles). From a practical perspective, it means a virtual taking over of the management roles and board getting involved in management roles. A bigger risk is, the key responsibilities of the Board get missed, because there is simply too much to cover and accountability gets diluted. As the proposal stand, the Independent Directors seem to perform quasi-management functions.

Conclusion

Given their role and complexity, PSBs are a significant player in the banking sector, and it is unrealistic to expect that governance challenges in the banking sector can be addressed without working through the governance issues that PSBs face. It is also unrealistic to expect that piecemeal and disjointed efforts – as has been the case in the past - will yield governance reforms that PSBs urgent need. The time is of essence and PSBs cannot be allowed to be a burden on exchequer to bear the burden of recapitalisation from time to time. Time and again, various expert committees including regulators have stressed the need for improving governance of PSBs to create PSBs as robust institutions. The RBIs reported suggestion (Economic Times editorial dated 5th Aug. 2020) to lower the government's equity stake in the banks it owns 26% makes eminent sense. The challenge of economic revival in the post Covid-19 context, and changing nature of banking call for urgent transformational reform in the PSBs. Only with transformative reforms, PSB will be able to reach its' potential and deliver results for the government and the country.

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[1] Report of the Committee to Review Governance of Boards of Banks in India. May 2014. https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/BCF090514FR.pdf

[2] Report of the Committee on HR Issues of Public Sector Banks. June 2010. https://financialservices.gov.in/sites/default/files/HRIssuesOfPSBs.pdf

[3] This comment is quoted to health care expert Paul Batalden on page 23 in the following book: Heath, Dan. (2020) Upstream. Transworld Publishers. London.

[4] Damodaran, M. (2020). Regulation – Sense and Sensibility. Expert Expressions. Expert Enablers Private Limited. https://www.excellenceenablers.com/nl-aug2020.html, https://www.msn.com/en-in/news/world/view-regulation-sense-and-sensibility/ar-BB17xWhy