

# Governance and related issues in commercial banks

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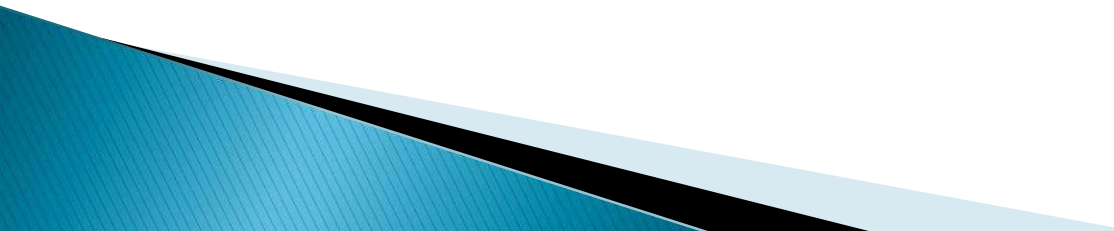
# Corporate Governance

- ▶ Governance in body corporates presents unique set of problems due to:
  - Separation of ownership from management
  - Which gives rise to 'agency related problems'
  - Resulting in 'Conflicts of Interests' (COI) situations
- ▶ Corporate Governance (CG) refers to 'Rules of the Game' to overcome agency related problems incldg. COI situations
  - Most important is to ensure that the interests of the owners and managers are as closely aligned as possible
  - Dual role of Managers – being Principal and Agent vis-à-vis the shareholders and customers including depositors – complicates the situation further
  - All professionals – doctors, lawyers, engineers incldg finance professionals fall in this category
  - Hence, Principals expect agents (managers) to be faithful agents for which **ethical behaviour of managers** most important, keeping at heart the interests of the owners and customers. This is the cornerstone of CG.
- ▶ Uniqueness of BR Act, 1949 – most of the proviso are aimed at mitigating / reducing COI situations without mentioning 'Corporate Governance' or 'Conflicts of Interest.'

# Corporate Governance (CG) in Banks

- Among corporates, banks are ‘special’
- Hence, CG in banks to be seen from a different perspective due to their ‘unique nature’
  - Apart from separation of owners and managers, they present additional challenges
  - Depositors – most important stakeholders rather than the shareholders
  - Both ‘systemically important’ and at once highly ‘leveraged’
  - Active participants in payments and settlement systems
  - Slight problem could lead to run on a bank leading to a domino effect
  - Foundation of banking– ‘TRUST’ and ‘CONFIDENCE’
  - The Board is the conscience keeper of such Trust and Confidence

# CG in banks – Elements thereof

- ▶ Ownership together with ‘fit & proper’ criteria
  - ▶ Risk Management
  - ▶ Conflicts of interests mitigation
  - ▶ Compensation practices
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# Corporate Governance in Banks – Risk Management

- Diverse interests of stakeholders result in diverse risk appetites
  - Shareholders interested in higher returns in the longer term
  - Management interested in higher returns in the shorter term
  - Both warrant higher risks to be assumed;
  - Depositors bothered about safety of funds – lower risk to be taken
- Balancing these diverse interests is the summum bonum of RISK MANAGEMENT by Top Management – Board of Directors and Top Management
- Hence, in Governance – Risk Management is one of the cornerstones
- Board should strive to benchmark the bank's Risk management with the best practices

# Corporate Governance in Banks – Risk Management

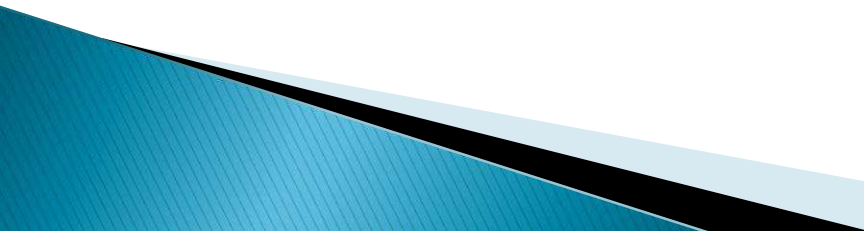
- Three lines of defence in Risk Management
  - First line – All the staff are required to ensure the effective management of risks within the scope of their direct organizational responsibilities
  - Second line – It comprises the Risk Control Owners, supported by their respective control functions. Risk Control Owners are responsible for ensuring that the residual risks within the scope of their responsibilities remain within appetite – Mid Office AND Compliance Function
  - Third line – The Audit function in the bank
- Board should first ensure that these three lines of defence are properly in place, their roles and responsibilities are clearly delineated and at any given point of time are spot on

# Ownership

In principle, ownership of banks should be:

- Well diversified
- Promoters to dilute shareholdings to 10% or less, as per roadmap submitted
- Owners / shareholders and directors – ‘fit and proper’
- Corporate Governance to be followed in letter and spirit
- Listing of shares – for providing liquidity and ensuring full disclosures
- Discussion point – Corporates as promoters of banks – Pros and cons ??


# Fit and proper criteria for owners/ shareholders

- Ownership structure has a large bearing on CG standards in a bank
  - Thorough due diligence of promoters at the time of setting up of the bank
  - Achieved through ‘acknowledgement’ – 5% and above and ‘prior approval’ – 10% and above
  - Below 5% – Due diligence is done only if they are acting in concert
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# Fit and Proper Criteria for directors

- ▶ To fulfill at the time of appointment and renewal of appointments + on an ongoing basis through annual declarations
- ▶ Nomination Committee
- ▶ Constitution of the Board – General conditions
  - Sec 10(A) – at least 51% of directors having specialised knowledge
  - Sec 16 – prohibition of common directors

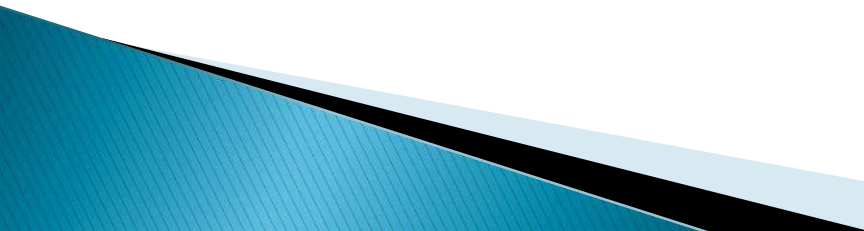
# Conflicts of interests (COI)

- RBI WG Report on COI – 2006
  - Ubiquitous ethical dilemmas
  - Represent governance issues in operational risk
  - Exploitation of COI situations is inconsistent with the role and responsibility of a director
  - Banks to have a COI policy
  - Board is essentially a policy making body besides deciding on matters beyond the delegated powers of the Chairman
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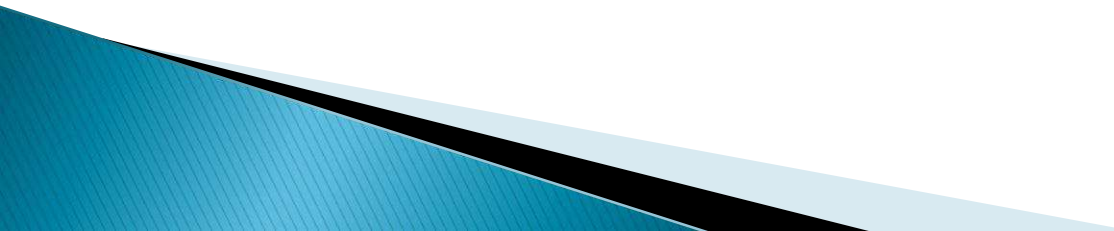
# Conflicts of interests (Contd)

- COI most acute when there is interference in the day to day administrative matters like:
  - staff matters – recruitment, promotion, transfer, deputation, etc,
  - credit proposals,
  - purchase of premises,
  - leasing of bank premises,
  - valuation of securities,
  - Empanelment of contractors, architects, doctors, lawyers, etc.
- Certain cases where directors visit branches, controlling offices or departments which are working at the operating level
- On such matters, more often than not conflicting groups are formed in the Board leading to lack of harmony
- Involvement in COI situations would weaken Board's ability to question the bank's actions
- Consequently, governance suffers

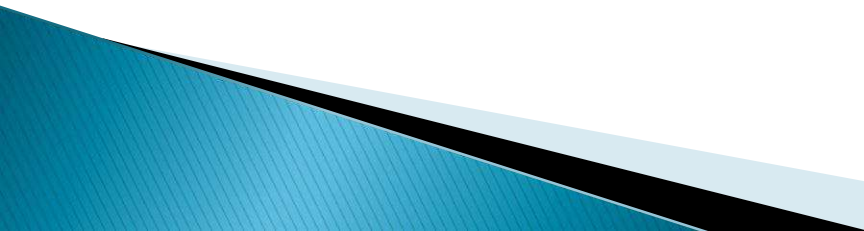
# Conflicts of interests (Contd)

- Continuing beyond 8 years through various methods
    - Getting reinducted again by co-optation or re-election – Against the spirit of Sec 10A(2A)(i)
  - Precludes fresh talent and inhibits broad basing of Board of Directors
  - In exceptional cases, a director can be reappointed after a minimum gap of 2 years
  - Role of independent directors
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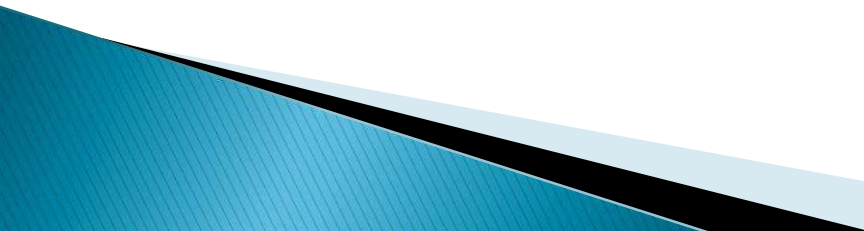
# Issues in Corporate Governance

- ▶ Separation of the posts of Chairman and Managing Director / Whole Time Directors in PSBs
  - ▶ Should ED be a part of Audit Committee?
  - ▶ Section 20 – Applicable to directors and not to shareholders !!!
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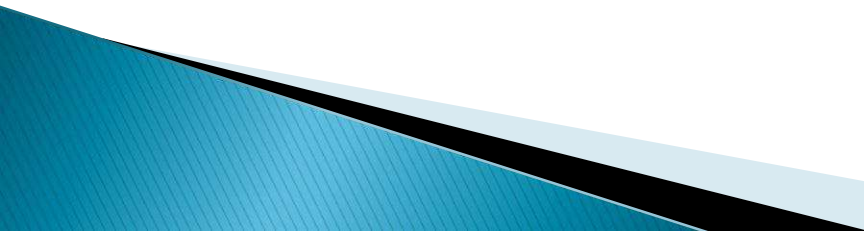
# Certain DO's and DON'Ts to mitigate COIs

- Not to directly send instructions any of the bank staff
  - Non-interference in the day to day functioning of the bank
  - Recuse oneself from the Board at the time of discussing an interested proposal
  - Ensure confidentiality about various info obtained by virtue of being the director of the company
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# Compensation practices in banking industry

- ▶ Tweaking compensation to align, as far as possible, the interests of the different stakeholders
  - ▶ Significant development in compensation regulation of banking industry
  - ▶ Though compensation was regulated by RBI as per statute, further regulatory steps taken to align to global standards
  - ▶ January 2012, based on FSB principles on sound compensation, RBI issued compensation guidelines
  - ▶ Importantly, compensation must be adjusted for all types of risks
  - ▶ Compensation outcomes must be symmetric with risk outcomes – malus and clawbacks
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# Compensation practices in banking industry (Contd)

- ▶ Variable pay not to exceed 70% of the fixed pay in a year
  - ▶ Deterioration in financial performance should generally lead to contraction in the total amount of variable remuneration paid.
  - ▶ ESOPs outside the computation of the total compensation. Nonetheless, ESOP should be reasonable.
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Thank You