Journal Homepage: - www.journalijar.com

INTERNATIONAL JOURNAL OF ADVANCED RESEARCH (IJAR)

Article DOI: 10.21474/IJAR01/13041
DOI URL: http://dx.doi.org/10.21474/IJAR01/13041

RESEARCH ARTICLE

STRUCTURE AND MECHANISM OF CORPORATE GOVERNANCE IN THE INDIAN BANKING SECTOR

C. Udayakumar Raju
Assistant Professor, Department of Science and Humanities, NBKR Institute of Science and Technology, Vidya Nager, Nellors Distict, AP.

Manuscript Info

Manuscript History
Received: 20 April 2021
Final Accepted: 18 May 2021
Published: June 2021

Key words:-
Corporate Governance, Structure, Mechanism, Obstacles and Measures for Good CG

Abstract

The banking sector serves as the main source of resource mobilization in developing economies. Due to underdeveloped money markets and capital markets, limited availability of financial instruments and a lack of confidence in the financial system, banks become the dominant financial intermediary in the system. Given the bank’s intermediary role in providing stability to the financial system, many emerging economies have implemented policies to develop and restructure the banking sector. Good corporate governance is designed to address this problem. Further, government regulations and frequent interventions reduce the incentive for effective monitoring and, at the same time, make supervision (or supervisors) less effective. The present paper an attempt is made to discuss about the Structure and Mechanism of Corporate Governance in the Indian Banking Sector.

Copy Right, IJAR, 2021,. All rights reserved.

Introduction:-

In this era of liberalisation and globalisation, corporate governance has become critical for banks to perform and remain competitive. Banks, in a broad sense, are financial institutions that deal with other people's money. A joint stock bank, also known as a commercial bank, is a company that specialises in banking. The protection of depositors' interests has become a top priority for banks. In banking jargon, Corporate Governance refers to managing a bank's affairs in such a way that all stakeholders, such as shareholders, bank customers, regulatory authorities, society at large, and employees, get a fair deal. Because of the nature of banking transactions, corporate governance is extremely important in the banking sector. Banking is a critical factor in a country's economic development. It is a country's life-blood. It is in charge of maintaining the economy's financial balances and the flow of credit. Banks have emerged as a tool of economic development and social justice in India since the nationalisation process. Banks must demonstrate exemplary corporate governance practises in their financial performance, transparency in their balance sheets, and compliance with other corporate governance rules, according to the Basel Committee Report 1999. Most importantly, their annual report should include accounting ratios for operating profit, return on assets, business per employee, nonperforming assets (NPAs), loan maturity profiles, advances, investments, borrowings, and deposits. Similarly, bank audit reports should highlight disclosures that comply with corporate governance guidelines. As a result, auditors should be fully aware of all aspects of the Reserve Bank of India's (RBI) latest guidelines and ensure that financial statements are prepared in a fraud-free manner, mirroring the implementation of corporate governance. Apart from the auditor's seriousness in incorporating those requirements into the audit report, banks' operational activities should have adequate internal control systems. For banks to

Corresponding Author:- C. Udayakumar Raju
Address:- Assistant Professor, Department of Science and Humanities, NBKR Institute of Science and Technology, Vidya Nager, Nellors Distict, AP.

maximise their returns on each unit of capital inducted through an effective funds management strategy and mechanism, they must pay close attention to their internal control systems. (Basel Committee Report, 1999)

Importance of Corporate Governance in Banks

Corporate governance is particularly important for banks, given the bank's important role in the financial sector. The rapid changes brought about by globalization, deregulation and technological advances are increasing risks in the banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. Theoretically, information asymmetry gives rise to agency problems and conflicts of interest between owners and managers. Good corporate governance is designed to address this problem. Further, government regulations and frequent interventions reduce the incentive for effective monitoring and, at the same time, make supervision (or supervisors) less effective. In this context, the corporate governance of banks becomes a more important challenge as compared to other firms. (Ahmed M. Khalid 2004)

Tracing the importance of Corporate Governance in Indian banks, quite a few facts are discerned. First, banks have an overwhelmingly dominant position in financial systems, and are extremely important engines of economic growth (King and Levine,1993; and Levine,1997). Second, as financial markets are usually underdeveloped, banks are typically the most important source of external finance for the majority of firms. Third, the economy is dominated by many small scale firms and most of them depend on banks. The governance of banks thus affects their governance structure. Fourth, as well as providing a generally accepted means of payment, banks also function as the main depositories for the through privatization/disinvestments and hence reducing the role of economic regulation. Economic regulations are getting replaced by prudential regulations, like capital adequacy norms, supervisory norms and many others. However, the prudential reforms already implemented in developing countries including India have not been effective in preventing banking crises (e.g. the recent Global Trust Bank and other cooperative banks failures) and the reasons can be traced to many, like poor legal structure, dominance of a docile shareholder i.e. Government, and asymmetry in information flow across the stakeholders. Although in comparison to many developing countries, India is better placed with respect to tapping the capital market for fulfilling necessary capital requirement, the need arises here to strengthen the regulations and to make governance more effective.

The concern for good governance from the state can be visualized from its oversight functions. In India the oversight function of Govt. is conditioned by three reasons (Leeladhar, 2004). Firstly, it is believed that the depositors, particularly retail depositors, are not able to effectively protect themselves as they do not have adequate information, nor are they in a position to coordinate with each other. Secondly, bank assets are unusually opaque, and lack transparency as well as liquidity. This condition arises due to the fact that most bank loans, unlike other products and services, are usually customized and privately negotiated. Thirdly, it is believed that there could be a contagion effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy.

As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, resulting in a run on the deposits and putting the entire financial system in jeopardy. Despite of such concerns from govt. side, the dominance of the latter and its central bank casts several doubts over their intentions. Another area of concern in Indian banking is the dominance of state owned banks. Government ownership thwarts competitive forces, limits the effectiveness of government supervision in the financial sector, and tends to meets use their state-owned institutions to support excessive government spending and favor less-than- creditworthy borrowers. All of these tendencies dampen overall economic growth (Litan et al, 2002). New private banks are generally good on accounting, but poor on accountability. They are more modern and computerized, but less risk conscious. One thing which is common to all is that cg is highly centralized with very little real check on the CEO, who is generally also closely linked to the largest owner groups. The enormous consequences of poor governance of banks come to limelight only in the case of banking crises/failures. It is of crucial importance therefore that banks have stronger cg than other corporate entities. (Jalan 2002).

Banking Sector Restructuring in India

At the time of independence, India's financial system at the time of independence was basically at limited services to cater to the demands of international commerce credit needs of large trading and manufacturing houses. India

started to nationalize the largely private-sector banks and concentrated them into a few large government banks in the early years of post-independence. The main central bank, the Reserve Bank of India (RBI), was established and made responsible for the co-ordination of nationalization and control plans. There were three bouts of nationalization, one immediately after independence in 1949 with the nationalization of the Imperial Bank of India, a second bout in 1969 and a third one in 1980.

The State Bank of India (SBI) was granted a license in 1955, with the objective to promote and expand SBI-affiliated banking facilities in the country and to provide access to deposit and credit facilities to a large population base including both rural and urban sectors. This resulted in a fast growth of the banking sector with a large number of bank branches available across the country. Fourteen banks were nationalized during the second round with eight more in March 1980. The structural result was that Indian banks moved from the private to the government sector. Under government control the banks basically provided the payment function but failed to develop the ability to assess and price investment risks. Later, the private sector was allowed to participate and some licenses were granted to domestic firms as well as foreign banks. This resulted in a mixed structure for the banking sector in India with 22 large nationalized banks owned and operated by the government, 29 domestic origin banks owned as joint-stock private companies and 24 foreign-origin banks.

The nationalized banks accounted for about 55 per cent of all retail banking activities in the late 1980s. These banks also had the largest network of branches, (61 per cent of the 61,000 branches in the country). It is surprising to see how the much less powerful 29 privately-owned commercial banks and the 24 foreign-origin banks managed to retain a 40 per cent share of the market in the 1990s! The Indian financial sector was heavily regulatory which reduced the efficiency of the industry. There were very high reserve requirements (at one time as high as 45 per cent of deposits), which channelled deposits into the central bank. There were 20 different schedules of interest rates. By controlling the minimum and maximum rates, the regulators were able to subsidize some activities more than others. As a result, a pervasive program of directing credits to certain economic activities developed.

The main banking sector reforms were implemented during 1992-94. The aims of these reforms were to introduce greater transparency, to improve investor protection, to enhance efficiency, to improve competition and to upgrade the standards of customer service. The liberalization that started in India about thirteen years ago has led to far-reaching changes in the financial structure. At present, India has 53 private-sector banks, which represent about one third of all banking activities.

The Reserve Bank of India (RBI) supervises all of the above-mentioned institutions and markets. It has direct responsibility for the licensing and supervision of financial institutions and more generally the responsibility for the smooth functioning of the entire financial system. In the pre-reform years of 1949-88, the RBI played a critical role in implementing policies to support the diversion of financial resources to the central government in order to carry out targeted credit programmes to expand industrial capacity and agricultural outputs. Nowadays, the RBI is more concerned with the deregulation of the financial sector, although retaining responsibility for overall macroeconomic stability. All banks are now required to extend credit to priority sectors, namely agriculture, small-scale industries and small businesses, at concessionary interest rates. Up until 1990, this directive applied to only the public sector banks but with deregulation this rule has been extended to the private sector banks as an ‘advisory’ guideline. In addition, 1 per cent of credits are required to be made to certain sections (the scheduled caste persons) of the community at a concessionary interest rate.

The government-owned banks, which still dominate the banking sector, are now under pressure to improve operational efficiency to compete with new entrants and now face increased scrutiny in relation to prudential norms. More private banks are now being licensed to increase competition in order to improve customer service. Some of the major reform measures undertaken are included. To sum up, India has been able to significantly reform its banking sector, which is essential to sustainable growth. However, with more active public and private banking sectors in place, there is a need to implement some “self- discipline” measures, or corporate governance guidelines.

The reforms aimed to increase bank profitability by lowering pre-emptions (by reducing the cash reserve ratio from 14% in 1994 to 3% in 2020-21, and the statutory liquidity ratio from 34.25 to 18%) and strengthening the banking system by imposing 9% capital adequacy standards, as well as prudential income recognition, asset classification, and hedging rules. In addition, competition enticed tech-savvy private and foreign banks to join the market.

23.3 percent of branches, 64% of deposits, and 75.1 percent of credit are held by the top 100 banking companies. This reflects the Indian financial system's risk aversion as well as the economy's business concentration. When it comes to agricultural credit, ten states account for 82 percent. Similarly, ten states account for slightly more than 65 percent of SME investments.

The Monetary Policy, which had previously been announced at half-yearly intervals to coincide with crop seasons, was moved to annual intervals, and then became more dynamic and flexible with quarterly reviews to accommodate some global economic changes.

PSBs, which account for over 88 percent of the total banking system, have moved from routine to universal banking, and their revenue share from third-party product sales has risen to around 20% of the total, proving to be banking's bane. The preference for selling third-party assets over core banking activities such as deposit-taking and credit disbursal is raising banking system risk levels. (Yerram Raju B, 2021)

Governance Mechanisms

Corporate governance mechanisms are a set of authorities and responsibilities that have an influence on management decisions and eliminate the managers' discretionary space. These mechanisms serve as a controlling tool for achieving a cost balance between principals and agents, as well as safeguarding stakeholders' interests. Corporate governance mechanisms, according to Hill and Jones (2004), are systems that improve coordination between the agent and principal relationship. Depending on the influence and relative importance of these tools, two types of mechanisms revolve around the corporate environment. Internal and external mechanisms within and outside the firm make up the two mechanisms. The board of directors, stakeholders, employee compensation schemes, and other internal processes and systems are all part of the internal mechanism. When a business goes off track and requires proper monitoring in internal proceedings as well as additional corrective measures, an internal control or mechanism is required. As part of internal governance monitoring, reporting lines are clearly defined, and business operations run smoothly, all of which contribute to the organization's success by separating the roles of responsibility, authority, and control in policy development. Auditors, market accessories such as market competition, product branding and selling policies, regulatory environment affecting the product, governance code of conduct to be adopted, stock exchange fluctuations, creditors and debtors, and so on are examples of external governance mechanisms. In general, a firm's stakeholders create an external governance mechanism in order for the company to operate in accordance with the parties associated with the firm, either independently or independently. External parties provide suggestions and guidelines to the firm during the annual general meeting for their best business operations, but it is up to the organisation to follow or ignore them.(Nidhi Sharma, 2017)

Internal Corporate Governance Mechanism

Although there is implicit government’s guarantee to bailout bank deposit for depositors of illiquid banks, the bailout process may take a lot of time. During the waiting time to get their money, depositors have lost time value of money and opportunities. Accordingly, they are willing to select banks which have credible commitment to depositors. Hence, it does not only rely on external corporate governance to force the management discipline, but also on the intention of bank managers and owners to inform the market about their intentions to implement the good corporate governance. This attention relies more on internal side rather than on external side, so-called internal corporate governance. Internal corporate governance is about mechanism for the accountability, monitoring, and control of a firm’s management with respect to the use of resources and risk taking (Llewellyn and Sinha 2000).

The Basel Committee on Banking Supervision (1999) relies on the responsibility of board directors and bank management on implementing good corporate governance. Nam (2004) suggests some aspects that should be focused on in the internal mechanism of corporate governance, including its independency and structure, function and activity, compensation and other relevant responsibilities of board of directors.

External Corporate Governance Mechanism

In common practices, depositors rely on the government role in protecting their bank deposits from expropriating management. It might encourage economic agents to deposit their funds into banks because a substantial part of the moral hazard cost is guaranteed by the government. In other words, even if the government may explicitly provide deposit insurance, bank managers probably still have an incentive to opportunistically increase their risk-taking, however it will bear the government’s expense. This moral hazard problem can be restored through the use of economic regulations such as asset restrictions, interest rate ceilings, reserve requirements, and separation of

commercial banking from insurance and investment banking. The effects of these regulations limit the ability of bank managers to over-issue liabilities or divert assets into high-risk ventures.

Thus, the special nature of banking requires not only a broader view of corporate governance but also government intervention through regulation and supervision in order to restrain the expropriating management behavior in banking sector. In this view, managers and owners are subject to the regulation. (Caprio and Levine, 2002) In general, the literature on bank regulation emphasises the stated purpose of regulation as that of maintaining the integrity of the market system. Recent attention is more focused on the role of government in the financial sector; government's participation as the owner of financial intermediaries, government's intervention in pricing and allocating credit, and government's role in regulating and supervising financial intermediaries. Regulation is commonly associated with the resolution of market failure in provision of the public good of financial stability. The characteristic limitations imposed are not concerned with market structure. (for examples barriers to entry or power of market monopoly). Instead, the constraints imposed by bank regulators in many countries attempt the opposite action.

Ciancanelli and Gonzales (2000) state that in banking sector the regulation and regulator represent external corporate governance mechanism. In the conventional literature on corporate governance, the market is the only external governance force with the power to discipline the agent. The existence of regulation means there is an additional external force with the power to discipline the agent. The force is quite different from the market. This implies that the power of regulation has different effects from those produced by markets. Bank regulation represents the existence of interests different from the private interests of the firm. As a governance force, regulation aims to serve the public interests, particularly the interests of the customers of the banking services. An agent of public interest, the regulator, also enforces regulation itself. This agent does not have a contractual relationship either with the firm's principal or with the banking organisations because of different interests from the principal.

Good Governance in Banking Sector - Obstacles

There are several reasons for the absence of an effective corporate governance mechanism in the Indian banking sector

Multiplicity of regulations:

Banks are governed by multiple enactments. For instance, private banks are governed both by the Companies Act, 1956 and the Banking Companies Regulation Act. The nationalized banks are governed both by the Banking Companies Regulation Act and the Bank Nationalization Act, 1969 (amended in 1982). The State Bank of India and its associates are governed by the State Bank of India Act, 1955 (amended in 1997), The regional Rural Banks are regulated by RRB Act, 1975, the Co-operative Banks by Cooperative Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1965. The RBI advisory group has opined that all the banks should be brought within the purview of a single Act which prescribes the various practices to be followed by all and one.

Lack of synchronization among various corporate governance norms:

Three different committees in India have dealt with the subject of corporate governance. These are: the Kumar Mangalam Birla Committee Report, 2000 that had been constituted by SEBI; CII Report, 1998 and the RBI advisory Committee Report, 2001. There is no synchronization of the regulations. Each report has dwelt on specific issues. It would be better if a common code is prescribed after harmonizing the recommendations of various committees.

Qualitative vs. Quantitative:

Banking norms are more quantitative than qualitative. Governance depends more on quality of adherence to the norms in addition to quantitative benchmark.

Mix up between ownership role and regulatory role:

In most of the financial institutions, the RBI has been a majority shareholder as well as the regulator. Narsimhan Committee on Banking Reforms raised the question as to whether regulators should be owners in the context of State Bank of India. Recently, RBI vacated its majority ownerships from Financial Institutions like Securities Trading Corporation of India Ltd. and Discount and Finance House of India and is in the process of total disinvestment. There is also no justification for a regulator like RBI to be represented on the Board of those regulated.

Mismatch between ownership pattern and board level representation:
Previously, Government used to be the majority shareholder in many of the financial representation on its board. With diversified ownership, private shareholders have begun to be given board level representation. But private shareholder representation is not commensurate with the extent of their shareholding.

Lack of transparency in selection of board members:
It is anybody's guess as to what are the considerations that weigh in making board level appointments. To have truly professional directors, there should be a process of transparent search.

Board Accountability:
Accountability of Directors in Public Sector Banks is another aspect on which processes have to be put in place. Directors must be made aware as to what they are expected to do on the boards. Their actual performance should be monitored and kept in view while reappointing them.

Lack of timely appointment of Directors:
Sometimes it takes a number of years to reconstitute the board of some of the public sector banks.

Political Boards:
Very often, board level appointments in the financial institutions are based on the political consideration. Board appointments must remain stable and unaffected by political developments.

Measures Taken by Banks towards Implementation of Best Practices
Prudential Norms:
in terms of income recognition, asset classification, and capital adequacy have been well assimilated by the Indian banking system. In keeping with the international best practice, starting 31st March 2004, banks have adopted 90 days' norm for classification of NPAs. Also, norms governing provisioning requirements in respect of doubtful assets have been made more stringent in a phased manner. Beginning 2005, banks will be required to set aside capital charge for market risk on their trading portfolio of government investments, which was earlier virtually exempt from market risk requirement.

Capital Adequacy:
All the Indian banks barring one today are well above the stipulated benchmark of 9 percent and remain in a state of preparedness to achieve the best standards of CRAR as soon as the new Basel 2 norms are made operational. In fact, as of 31st March 2004, banking system as a whole had a CRAR close to 13 per cent.

On the Income Recognition Front:
There is complete uniformity now in the banking industry and the system therefore ensures responsibility and accountability on the part of the management in proper accounting of income as well as loan impairment.

ALM and Risk Management Practices:
At the initiative of the regulators, banks were quickly required to address the need for Asset Liability Management followed by risk management practices. Both these are critical areas for an effective oversight by the Board and the senior management which are implemented by the Indian banking system on a tight time frame and the implementation review by RBI. These steps have enabled banks to understand, measure and anticipate the impact of the interest rate risk and liquidity risk, which in deregulated environment is gaining importance. (Leeladhar v.2004)

Conclusion:-

Globalization and liberalisation are sweeping the economy, and the banking industry is no different. Banks will face a variety of risks in this era of revolutionary change, and managing these risks will be one of their future challenges. Organizations that adopt good corporate governance and best practises will be able to survive and achieve sustainable growth levels in a competitive business environment. In a deregulated environment, public sector banks require more functional autonomy. Such autonomy, however, must be accompanied by greater stakeholder accountability on the part of their boards. A Corporate Governance Policy will be a useful tool in achieving this objective. The success of corporate governance is dependent on banks' awareness of their own responsibilities. While the law can regulate and control certain practises, it is the banks' ultimate responsibility to be ethical and moral. This enlightenment is what will bring banks closer to their objectives.

References:-

1. Ahmed M. Khalid, Bond University, Australia & Muhammad Nadeem Hanif, PIDE May 2004 corporate governance of banks in Pakistan: a profile
2. Basel Committee on Banking Supervision (BCBS) (1999) “Enhancing Corporate Governance
3. for Banking Organizations”, Bank for International Settlements, Switzerland.
4. Capiro, G, Jr and Levine, R (2002), “Corporate Governance of Banks: Concepts and International Observations”, paper presented in the Global Corporate Governance Forum Research Network Meeting, April 5.
5. Ciancanelli, P. and Gonzalez, J.A.R. (2000), “Corporate Governance in Banking: A Conceptual Framework”, Social Science Research Network, Electronic Paper. http://papers.ssrn.com/paper.taf?abstract_id=253714
6. Jalan, Bimal, Inaugural address at NIBM Annual Day (6th January) on the theme of Corporate a Governance in Banks and Financial Institutions, NIBM, 2004.
7. King, R. G. and Levine, R., ―Finance, Entrepreneurship and Growth: Theory and Evidence, Journal of Monetary Economics, Vol.32, 1993,
8. Litan, Pomerliano and Sunderrajan., “Strengthening Financial Sector Governance in Emerging Markets”, Chap-1, World Bank, 2002.
9. Leeladhar.V (2004), Deputy Governor, Reserve Bank of India on November 27, 2004 at the “Sheth Shantaram Mangesh Kulkarni Memorial Lecture” organised by The North Kanara G.S.B. Co-op Bank Ltd.
10. Llewellyn, D. and Rajeeva, S. (2000), “Monitoring and Control of Banks: The Role of Regulation and Corporate Governance”, Reddy, Y. R. K. and Raju, Y (ed) Corporate Governance in Banking and Finance, Tata McGraw-Hill Publishing Co. Ltd., New Delhi.
11. Mangesh Kulkarni Memorial Lecture” organised by The North Kanara G.S.B. Co-op Bank Ltd.
12. Nidhi Sharma, 2017, Corporate Governance Mechanisms in India, Sharma Nidhi; International Journal of Advance Research and Development. (Volume2, Issue5) Available online at www.ijarnd.com
13. Yerram Raju B, 2021, Banking sector wobbly even after reforms, Updated on March 25, 2021, https://www.thehindubusinessline.com/opinion/banking-sector-wobbly-even-after-reforms/article34163090.ece , retrieved on 19-06-2021.