Building Corporate Image through Corporate Governance in Indian Banking Industry

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Abstract

The concept of corporate governance has been demanding a lot of attention and has moved centre stage in the wake of corporate failures and widespread dissatisfaction with the way many corporate function, thus becoming a widely discussed topic across the globe recently. Corporate governance is now recognised as a paradigm for improving competitiveness and enhancing efficiency and thus improving investors' confidence and accessing capital, both national and international. As a result, corporate governance has become a dynamic concept and is no more a static one. Banks form a crucial link in a country's financial system because of which it is universally considered to be a regulated industry and their well-being is imperative for the economy. The concept of corporate governance is different for banks. The business model of financial intermediaries especially of banks focuses dealing in the financial resources of others and most of their liabilities constitute debt which is in the form of deposits. Banks are interconnected in diverse, complex and often opaque ways underscoring their "contagion" potential. If a corporate fails, the fallout can be restricted to the stakeholders. But in case a bank sinks, the impact can spread rapidly through to other banks with potentially serious consequences for the entire financial system and the macro economy. It would, however, be erroneous to conclude that regulatory oversight is a substitute to corporate governance. There exists complementarity between regulation and corporate governance in banking. This paper discusses the corporate governance as an internal mechanism in banks, its necessity in the banking sector, the history of corporate governance in the world as well as India, best practices of corporate banking incorporated in India and measures taken to implement them and the recent developments in this area in the banking sector.

Key words: *Corporate Governance, Banking Sector, Internal Working Methods.*

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Introduction

Banks play a pivotal role in the financial and economic system of a nation. Hence, bank failure due to unethical or incompetent policies and management action is extremely detrimental to the shareholders, the depositing public and the economy at large. Owing to this fact, a proper corporate governance system is most crucial for banks and other financial institutions. The corporate governance of banks in developing economies is important for several reasons. First, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth (King and Levine 1993a,b; Levine 1997). Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms. Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings.

Consequently, managers of banks in these economies have obtained greater freedom how they run their banks. The banking industry is one of the most regulated industries in India. Since the opening up of the economy in 1991 the banking industry has experienced a gradual phased deregulation. A number of reforms have been initiated in this sector ranging from interest rate liberalisation to restructuring of the public sector banks to increased competition and hence efficiency. The banking sector in India has undergone structural changes during the last decade. Today, the public sector banks (PSBs) which earlier provided plain services are competing with a large number of private banks and foreign banks which utilise different innovative approaches and services.

Concept of Corporate Governance

The narrow approach to corporate governance has a view that the subject is the mechanism through which shareholders are assured that managers will act in their interests. Indeed, as far back as Adam Smith, it has been recognised that managers do not always act in the best interests of shareholders (Henderson, 1986). This problem has been especially exacerbated in the Anglo-Saxon economies by the evolution of the modern firm characterised by a large number of shareholders, leading to a separation of ownership and control (Jensen and Meckling, 1976; Fama and Jensen, 1983).

However, there is a broader view of corporate governance, which views the subject 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 (Shleifer and Vishny 1997, Vives 2000, Oman 2001).

A further issue, which complicates the corporate governance of banks in developing economies, is the activities of 'distributional cartels' (Oman, 2001). These cartels consist of corporate insiders who have very close links with or partially constitute the governing elite. The existence of such cartels will undermine the credibility of investor legal protection and may also prevent reform of the banking system.

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". 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).

The literature on corporate governance in its wide subtext covers a variety of aspects, such as protection of shareholder's rights, improving shareholders' value, and board matters etc.

Corporate governance is a term that refers broadly to the rules, processes, or laws, by which businesses are operated, regulated, and controlled. The term can refer to internal factors defined by the officers, stockholders or constitution of a corporation, as well as to external forces such as consumer groups, clients, and government regulations. Corporate governance has evolved from being a mere compliance issue to an important element which delivers value to businesses that adopt the best governance practices. This concept deals with the entire framework of legal, cultural and institutional arrangements what an organisation like a bank can do, who controls them, how that control is exercised and how the risks and returns from the activities they undertake are allocated.

Corporate Governance in the Indian Banking Sector

Almost eighty percent of the total banking operation in India is under the control of the public sector banks consisting of the nationalised banks, the State Bank of India and its subsidiaries. The issues pertaining to Corporate Governance becomes more critical in case of these banks as the controlling power of these banks link with the Government. The Government is vested with simultaneous function of owner, manager and semi-regulator or even at times as a super regulator. Government ownership is one of the primary issues that can have a direct impact on the quality of corporate governance. In public sector banks, the rights of the private shareholders are considerably curtailed as their approval is not required for paying dividend or formalising the annual accounts. The importance of Corporate Governance issues in public sector banks is important, due to two principal reasons. First, they constitute a huge share of business in the banking industry in India, and second, it is highly unlikely that they are going to be phased out in due course. Though the general principle of Corporate Governance is valid for the public sector entities, but they simply cannot imitate the private sectors banks in this respect. Things start getting worse, when uncertainties looms involving ownership issues, and the public ownership being treated as a transitional phenomenon. Further, expectation of change in ownership (dilution of Government Stake) can result in the change of institutional structure of significance difference. When Government is the owner, it is accountable to the political institutions, which in turn may not have pure economic motives in mind. A mixed ownership structure can bring the different objectives of shareholding on a common platform and help in reconciling them. Issues relating to the separation of ownership and management in both private and public sectors banks needs to be addressed, in contrast to the traditional Corporate Governance issues stemming from the outside financial, in developing countries and especially in India, things are a bit different. Here, the grueling question is not how the outside financiers (shareholders) exert management control, but also as to how they can (including minority shareholders) exercise control over the big inside shareholders.

Key Corporate Governance Parameters and Compliance Status in Indian Banks

Following are some important parameters that can help determine the implementation of corporate governance in Indian public and private banks:-

- Bank's Philosophy on Corporate Governance,
- Board of Directors,
- Committee of the Board like audit committee, Investor's Grievance Committee, Remuneration committee etc. and
- Best Practices in Corporate Governance.

Observations

Indian banks lag far behind their foreign counterparts where disclosing information to the public is concerned. Wake of increased competition from foreign banks, disclosure norms are very important differentiating factor to attract and retain big corporate clients. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly emerging business areas like micro finance, commitment to better customer service, adequate automation and proactive policies on house-keeping issues, banks will definitely be able to cope up with these challenges and convert them into opportunities.

Corporate Governance in banking sector is very much in demand due to global awareness regarding corporate governance and global banking to ensure transparent service to citizens. Proper and adequate corporate governance can handle many complex banking issues and will create a transparent globalised economic environment. Major concerns like 'Insider trading', 'selective release of sensitive information', and 'resorting to unfair accounting practices' are the biggest concerns from the Corporate Governance perspective. However, adequate corporate governance practices implemented by banks helps bank to ensure shareholder's interest in the long run. "Ensuring transparency in financial statements" and "expected on ethical behaviors" and "Protecting shareholders' interest" are the key attributes of good Corporate Governance. Adherence to those attributes ensures transparency of banking transactions and minimises the chance of fraud and malpractices.

Corporate Governance is as important as other quantifiable factors, such as likely growth in earnings, from the point of view of investment decisions. Since, the outcome of some attributes minimises the chances of fraud, it enhances shareholder's confidence; as a result increases share value. The most important factor while studying Corporate Governance in a bank is the perceived integrity of financial statements. The facts that well governed banks are less likely to indulge in malpractice andmis-governance and more likely to protect the interests of minority shareholders. Not only that it protects the public fund by acting like a watchdog, it inculcates the habits of ethics in business.

Conclusion

The development of norms and guidelines are an important first step in a serious effort to improve corporate governance. There is a need for a strong culture of compliance at the top of the organisation and it will be necessary to consider how management can respond appropriately to ethical or reputation concerns that come to their knowledge.

The bigger challenge in India, however, lies in the proper implementation of those rules at the ground level. Corporate governance does not end with commercial banks. It is imperative to extend the principles of good corporate governance practices to cooperatives, PDs, NBFCs and other financial institutions. Even the most prudent norms can be hoodwinked in a system plagued with widespread corruption. Nevertheless, with industry organisations and chambers of commerce themselves pushing for an improved corporate governance system, the future of corporate governance in India promises to be distinctly better than the past.

"Corporate Governance is the only royal road to the portal of corporate success and there is no short cut to achieve the same. A short cut can lead to short circuiting, which can cause colossal loss to the banks concerned" [Dr. Y. V. Reddy, governor of RBI].

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