Banking Industry and Economical Growth- A Governance Approach.

BY : Dr. Bension Jacob & Dr. Atul Mehrotra.

Abstract

Integration of economies leads to integration of financial markets catalyzing the globalisation process. The growing role of the financial sector in allocation of resources has significant potential advantages for the efficiency with which our economy functions. Consequently, the adverse consequences of malfunction of the financial system are likely to be more severe than they used to be in the past. Hence, all our efforts today should be focused at ensuring greater financial stability. The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation along with the increasing levels of competition have facilitated globalisation of the India banking system and placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges.

In view of the importance of the banking system for financial stability, sound corporate governance is not only relevant at the level of the any individual bank, but is also a critical ingredient at the system level. Effective risk management systems determine the health of the financial system and its ability to survive economic shocks. To a large extent, many risk management failures reflect a breakdown in corporate governance which arise due to poor management of conflicts of interest, inadequate understanding of key banking risks, and poor Board oversight of the mechanisms for risk management and weak audit system.

Key Words: Corporate Governance, Banks and Financial Institutions, Risks, Regulators, Supervisors

Introduction

The importance of corporate governance in Banks

- Corporate governance is the mechanism/system by which Banks are directed and controlled.
- Good corporate governance is a key element in improving economic efficiency.
- Conversely, bad corporate governance, ***particularly in banks***, can undermine economic and financial stability.
- The Asian Crisis demonstrated this.

The role of bad corporate governance in the Asian crisis

Weak corporate governance in Asian banks (and their customers) was one of the key factors in the Asian crisis:

- many banks were controlled by owner-managers and the board of directors played little role;
- banks were often parts of wider conglomerates and used to fund other parts of the group or the owners (connected lending);
- banks were subject to political influence in their lending decisions;
- management was weak and lacked self-responsibility;
- growth was more important than return on capital; and
- risk management was poor due to:

- lack of credit controls and skills
- excessive risk concentrations in individual borrowers and sectors
- excessive funding and currency mismatches

Corporate governance is, therefore, the foundation stone for effective risk managements in banks and thus the foundation for a sound financial system. Therefore, the choices, which banks make when they establish their risk management and corporate governance systems have important ramifications for financial stability. These systems can affect how the institution functions and how others perceive it in the marketplace. The last decade has witnessed major changes in the financial sector - new banks, new financial institutions, new instruments, new windows, and new opportunities - and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Demand for new products, particularly derivatives, has required banks to diversify their product mix and effect rapid changes in their processes and operations in order to remain competitive in the globalised environment.

Few broad challenges Indian banks are facing in the number of areas are - enhancement of customer service; application of technology; implementation of Basel II & III; improvement of risk management systems and outsourcing of risks; alignment of regulatory accounting requirements, implementation of new accounting standards/IFRS; enhancement of corporate governance norms by way of better transparency & disclosures; and compliance with KYC aspects.

Before coming to important aspect of enhancement of corporate governance, I feel to touch upon few important challenges as quoted herein above and which have direct or indirect bearing on the governance matter.

Salient features of Basel II Accord

Some of the key aspects of the Basel II are:

- Banks at different levels of risk management systems could still adopt Basel I as it provided a menu of approaches for measuring capital requirements for credit, market and operational risks In India, for example, we adopted Standardized, Standardized and Basic Indicator Approaches for credit, market and operational risks effective from March 2009 for banks with overseas presence and foreign banks and from March 2009 for other commercial banks (excl. RRBs & LABs)
- By reckoning the ratings provided by the rating agencies, much needed risk differentiation with in risk categories was brought in
- Enhanced collateral recognition offered an incentive to banks to manage their collateral effectively, thus reducing the risks in their books
- Bank's internal methods were recognized for capital measurement
- Pillar 2 brought in the required discipline among banks for making a self-assessment. Further it sought to strengthen the dialogue between regulator and the regulated entities
- Disclosure standards empowered the stakeholders to monitor the banks effectively

- Regulators were provided with several discretions so as to enable them to suitably implement the accord

Thus, when the Basel II was rolled out in various jurisdictions, a sense of achievement among regulators could be gauged. Even some of the regulators felt, given the menu of approaches and flexibility in Basel II, there would be no occasion to come out with another Capital Accord. However, the adoption of Basel II was not uniform across jurisdictions. While Europe embraced the Basel II implementation willingly, USA conveyed that they would implement only in respect of Top 10 banks. Some countries preferred to announce that their top 5 or 10 banks would adopt advanced approaches straightaway, as these banks' best practices only were reflected in the Basel II norms.

However, in some jurisdictions like India, regulators announced that all the banks would first adopt basic approaches and announced a timeline for voluntary migration to Basel II advanced approaches over a period of time as the risk management systems in those jurisdictions were either not fully developed or not evenly developed and the availability of data was also a source of concern. By the time the Global Financial Crises was recognized in a meaningful way, the Basel II implementation even in some of the developed countries was not complete.

Salient features of Basel 2.5 Accord

During the crises, many risks were not appropriately covered in the risk-based regime. For example, some banks held significant volumes of complex, illiquid credit products in their trading books without a commensurate amount of capital to support the risk. Moreover, failure to capture major on- and off- balance sheet risks, as well as derivative related exposures, was the key factor that amplified the crises.

In response, in July 2009 the Committee introduced a set of enhancements to the capital framework aimed at the following:

- Considerably strengthen the minimum capital requirements for complex securitizations
- Higher risk weights for re-securitization exposures to better reflect the risk inherent in these products
- Raising the capital requirements for certain exposures to off-balance sheet vehicles
- Stressed value-at-risk requirement for the trading book
- An incremental risk charge for migration and default risk in trading book and
- Higher requirements for structured credit products held in the trading book.

The July 2009 amendment to the Basel Accord is generally referred as Basel 2.5 and was the first attempt by the Committee to fix the problems. These changes were incorporated in the New Capital Adequacy Framework circular issued by the Reserve Bank of India in the month of February 2010.

Basel III Accord

Group of Central Bank Governors and Heads of Supervision announced substantial strengthening of the existing capital requirements after its meeting on September 12, 2010.

Basel III is far-reaching and multi-pronged approach. The effectiveness of the proposed changes is to be seen over a period. However, one thing is sure; we are into interesting times, yet again.

A summary of Basel III proposals:

Micro Prudential Measures:

A. **Capital Measures:**
   a. Quality and quantity of capital:
      i. Common Equity requirement of 4.5% (to be achieved by 1st Jan., 2015)
      ii. Capital conservation buffer of 2.5% - in common equity – (to be achieved by 1st jan., 2019)
      iii. Counter-cyclical buffer of 0% to 2.5% - in common equity – (in select jurisdictions where credit growth is excessive and contributes to systemic risks build-up)
      iv. Deductions – Losses, Goodwill, net DTA, significant investments in financial institutions – phased in over a period till 1st Jan., 2019
      v. Calibration of risks- of Assets and off-balance sheet exposures;

B. **Liquidity Measures:**
   a. Liquidity Coverage Ratio (LCR)
   b. Net Stable Funding Ratio (NSFR)

C. **Risk Management and Supervision:**
   a. Liquidity Risk Management
   b. Valuation Practices
   c. Stress Testing
   d. Sound Compensation Practices
   e. Corporate Governance
   f. Supervisory Colleges

D. **Market Discipline:**
   a. Trading Book related disclosures
   b. Securitization and Off-balance sheet vehicle related disclosures
   c. Elements of regulatory capital and deductions
   d. Reconciliation to financial accounts
   e. Compensation related disclosures

Compliance with international standards

One of the prime international standards considered relevant for ensuring a safe and sound banking system is the ‘Revised Core 29 Principles for Effective Banking Supervision’ issued by the Basel Committee on Banking Supervision (BCBS) in 2012. Financial reporting under IFRS and prudential supervision has slightly different perspectives. While the former is oriented

towards capturing the historical position, the latter has a forward-looking element particularly with reference to measurement of impairment and capital. An important challenge, therefore, is to ensure that accounting standards and prudential frameworks are mutually consistent. While working towards achieving this consistency between the two sets of standards, it is essential for the regulators to be in a position to address any implications that the changes in accounting standards may have for the safety and soundness of banks.
Derivative activity in banks in India has been increasing at a brisk pace. While the risk management framework for derivative trading, which is a relatively new area for Indian banks (particularly more in respect of structured products), is an essential pre-requisite, the absence of clear accounting guidelines in this area is matter of significant concern. It is widely accepted that as the volume of transactions increases, which is happening in the Indian banking system, the need to upgrade the accounting framework needs no emphasis.

The World Bank's ROSC on Accounting and Auditing in India has commented on the absence of an accounting standard, which deals with recognition, measurement, presentation and disclosures pertaining to financial instruments. The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) has already considered the issue of Accounting Standards on the above aspects pertaining to financial Instruments. These will be the Indian standards parallel to International Financial Reporting Standard 7, International Accounting Standards 32 and 39. The proposed Accounting Standards will be of considerable significance for financial entities and could therefore have implications for the financial sector. In the meanwhile, the Reserve Bank is considering the need for banks and financial entities adopting the broad underlying principles of IAS 39. Since this is likely to give rise to some regulatory / prudential issues, all relevant aspects are being comprehensively examined. The proposals in this regard would, as is normal, be discussed with the market participants before introduction. Adoption and implementation of these principles are likely to pose a great challenge to both the banks and the Reserve Bank.

Outsourcing risks

Banks are increasingly using outsourcing for achieving strategic aims leading to either rationalisation of operational costs or tapping specialist expertise, which is not available internally. 'Outsourcing' may be defined as *a bank's use of a third party, including an affiliated entity within a corporate group, to perform activities on a continuing basis that would normally be undertaken by the bank itself.* Typically outsourced financial services include applications processing (loan origination, credit card), document processing, investment management, marketing and research, supervision of loans, data processing and back office related activities etc.

Outsourcing might give rise to several risks including, strategic risk, reputation risk, compliance risk, operational risk, exit strategy risk, counterparty risk, country risk, access risk, concentration risk and systemic risk. The failure of a service provider to provide a specified service, ensure security/ confidentiality, and comply with legal and regulatory requirements can lead to financial losses/ reputational risk for the bank and could lead to systemic risks for the entire banking system in a country. It would therefore be imperative for the bank outsourcing its activities to ensure effective management of these risks. It is in this background that RBI has issued draft guidelines on outsourcing, which is intended to provide direction and guidance to banks to effectively manage risks arising from such outsourcing activities. The underlying principles for any outsourcing arrangement by a bank are that such arrangements should neither diminish the bank's ability to fulfill its obligations to its customers and the RBI nor impede effective supervision by RBI.

Outsourcing banks, therefore, should take steps to ensure that the service provider employs the same high standard of care in performing the services as would be employed by the banks if the activities were conducted within the banks and not outsourced. Accordingly, banks are not expected to outsource any activity that would result in their internal control, business conduct, or reputation being compromised or weakened.

Application of advanced technology

Technology is a key driver in the banking industry, which creates new business models and processes, and revolutionises distribution channels. Banks, which have made inadequate investment in technology, have consequently faced an erosion of their market shares. The beneficiaries are those banks, which have invested in technology. Adoption of technology also enhances the quality of risk management systems in banks and in turn the good governance. Recognising the benefits of modernising their technology infrastructure banks is taking the right initiatives. While doing so, banks have various options to choose from: they can build a new system themselves, or buy best of the modules, or buy a comprehensive solution, or outsource. In the context banks need to clearly define their core competencies to be sure that, they are investing in areas that will distinguish them from other market players, and give them a competitive advantage[6]. A further challenge, which banks face in this regard, is to ensure that they derive maximum advantage from their investments in technology and avoid wasteful expenditure, which might arise because of uncoordinated and piecemeal adoption of technology; adoption of inappropriate/ inconsistent technology and adoption of obsolete technology.

Enhancing corporate governance

The issues related to corporate governance have continued to attract considerable national and international attention in light of a number of high-profile breakdowns in corporate governance. This becomes all the more relevant for banks since they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but also leverage such funds through credit creation. Banks are also important participants in the payment and settlement systems. In view of the above, legal prescriptions for ownership and governance of banks in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time. In view of the importance of the banking system for financial stability, sound corporate governance is not only relevant at the level of the individual bank, but is also a critical ingredient at the system level. Effective risk management systems determine the health of the financial system and its ability to survive economic shocks. To a large extent, many risk management failures reflect a breakdown in corporate governance which arise due to poor management of conflicts of interest, inadequate understanding of key banking risks, and poor Board oversight of the mechanisms for risk management and internal audit.

Corporate governance is, therefore, the foundation for effective risk managements in banks and thus the foundation for a sound financial system. Therefore, the choices, which banks make when they establish their risk management and corporate governance systems have important ramifications for financial stability. These systems can affect how the institution functions and how others perceive it in the marketplace.

A good "governance culture" is crucial for financial stability but since it is an 'intangible', rules may not be able to capture its essence effectively. Therefore, banks may have to cultivate a good governance culture building in appropriate checks and balances in their operations. There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances: (1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs. Although some ownership structures might have the potential to alter the strategies and objectives of a bank, these banks will face many of the same risks associated with weak corporate governance. Consequently, the general principles of sound corporate governance should also be applied to all banks irrespective of their unique ownership structures.

Measures taken by regulator towards corporate governance

Reserve Bank of India has taken various steps furthering corporate governance in the Indian Banking System. These can broadly be classified into the following three categories:

1. Transparency
2. Off-site surveillance
3. Prompt corrective action Transparency and disclosure standards

1. Transparency and accounting standards in India have been enhanced to align with international best practices. However, there are many gaps in the disclosures in India vis-à-vis the international standards, particularly in the area of risk management strategies and risk parameters, risk concentrations, performance measures, component of capital structure, etc. Hence, the disclosure standards need to be further broad-based in consonance with improvements in the capability of market players to analyse the information objectively.
2. The off-site surveillance mechanism is also active in monitoring the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI also brings out the periodic data on ―Peer Group Comparison on critical ratios to maintain peer pressure for better performance and governance.
3. RBI has adopted prompt corrective action as a part of core principles for effective banking supervision. As against a single trigger point based on capital adequacy normally adopted by many countries, Reserve Bank in keeping with Indian conditions have set two more trigger points namely Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability. These trigger points will enable the intervention of regulator through a set of mandatory action to stem further deterioration in the health of banks showing signs of weakness.

The Indian scenario

Nowhere is proper corporate governance more crucial than for banks and financial institutions. Given the pivotal role that banks play in the financial and economic system of a developing country, bank failure owing to unethical or incompetent management action poses a threat not just to the shareholders but also to the depositing public and the economy at large.
Two main features set banks apart from other business – the level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities. The opaqueness in banking creates considerable information asymmetries between the "insiders" – management – and "outsiders" – owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of banks as well as siphon off funds. It is, therefore, much more difficult for the owners to effectively monitor the functioning of bank management. Existence of explicit or implicit deposit insurance also reduces the interest of depositors in monitoring bank management activities. It is partly for these reasons that prudential norms of banking and close monitoring by the central bank of commercial bank activities are essential for smooth functioning of the banking sector. Government control or monitoring of banks, on the other hand, brings in its wake, the possibility of corruption and diversion of credit of political purposes, which may, in the long run, jeopardize the financial health of the bank as well as the economy itself.

The reforms have marked a shift from hands-on government control interference to market forces as the dominant paradigm of corporate governance in Indian banks. Competition has been encouraged with the issue of licenses to new private banks and more power and flexibility have been granted to the bank management both in directing credit as well as in setting prices. The RBI has moved to a model of governance by prudential norms rather from that of direct interference, even allowing debate about appropriateness of specific regulations among banks. Along with these changes, market institutions have been strengthened by government with attempts to infuse greater transparency and liquidity in markets for government securities and other asset markets.

This market orientation of governance disciplining in banking has been accompanied by a stronger disclosure norms and stress on periodic RBI surveillance. From 1994, the Board for Financial Supervision (BFS) inspects and monitors banks using the "CAMELS" (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. Audit committees in banks have been stipulated since 1995. Greater independence of public sector banks has also been a key feature of the reforms. Nominee directors – from government as well as RBIs – are being gradually phased off with a stress on Boards being more often elected than "appointed from above". There is increasing emphasis on greater professional representation on bank boards with the expectation that the boards will have the authority and competence to properly manage the banks within the broad prudential norms set by RBI. Rules like non-lending to companies who have one or more of a bank's directors on their boards are being softened or removed altogether, thus allowing for "related party" transactions for banks. The need for professional advice in the election of executive directors is increasingly realized.

As for old private banks, concentrated ownership remains a widespread characteristic, limiting the possibilities of professional excellence and opening the possibility of misdirecting credit. Corporate governance in co-operative banks and NBFCs perhaps need the greatest attention from regulators. Rural co-operative banks are frequently run by politically powerful families as their

personal fiefdoms with little professional involvement and considerable channeling of credit to family businesses. It is generally believed that the "new" private banks have better and more professional corporate governance systems in place. However, the recent collapse of the Global Trust Bank has seriously challenged that view and spurred serious thinking on the topic.
CG among Indian banks is discussed across three broad categories - the state-owned banks, the "new" private sector banks (i.e. those that were given a banking licence in 1993), and the "old" private sector banks. At the risk of over simplifying, Fitch has drawn conclusions regarding banks in each of these groups, although standards of individual banks might be better or lower than the "median" governance practices discussed. There are 27 state owned banks in India, accounting for 75% of banking-system assets. Government ownership varies from 51%-100%. The state-owned banks are governed by the Banking (Acquisition and Transfer of Undertakings) Act, which gives sweeping powers to the government. These banks have begun to list their equity on the domestic bourses, and have needed to comply with disclosure and good CG guidelines stipulated by the stock exchanges, which focus on the rights of minority shareholders. It is worth mentioning that boards, including executive chairperson and "independent" directors, are still determined by the government; and power is concentrated with the executive chairperson, who is generally appointed on account of seniority.

The signs are that intervention by the state in state-owned banks' credit operations is declining. Direct intervention in decisions is being replaced by "policy directed" lending aimed at achieving the broader social objectives of the government in power. Increasingly decisions are based on commercial considerations, partly stemming from the bank's public listings and partly because of more investment in technology that brings greater transparency and is helping to standardize decision-making. Foreign ownership of some shares in some banks and frequent interaction with large institutional investors has maintained pressure on these banks to adopt more progressive CG standards. Summing up, although there has been an improvement in the governance practices of these banks, the ownership overhang still remains, and they still comply more with the letter of governance practices than the spirit. In India, CG standards are the highest among new private sector banks.

Two of these, HDFC Bank (rated on Fitch's national scale for India at ‗AAA(ind)', with n individual rating of 'C') and ICICI Bank (IDR 'BB+' on Fitch's international scale and also with an individual rating of 'C'), are listed on the New York Stock Exchange, and UTI Bank (rated 'AA+(ind)' and 'C/D') is listed on the London Stock Exchange. These banks adhere to the governance practices and disclosures expected by international investors. The boards of these banks are reasonably broad based, with independent directors of wide-ranging experience.

Anecdotally, the various board committees (compliance, audit, risk, compensation) are vocal, particularly in the internationally listed banks. All this has had a knock-on effect on the other domestic banks. In sharp contrast, the old private sector banks have the weakest level of governance. These banks are controlled by a few families or by communities, with non-bank interests. While these banks might have outside directors and various board committees, these tend to be passive with real decision-making concentrated with the large shareholders - increasing the chance of related party lending. The Reserve Bank (RBI), India's central bank, is focused on governance issues both from the perspective of improving the quality of its oversight and from securing the interests of depositors through transparency, off- site surveillance and prompt corrective action. The RBI has established two major committees to look into governance at the banks and discusses these jointly with the chief financial officer of the bank. As these banks appoint auditors for only a three-year period, it has not been feasible for one audit firm to build the necessary infrastructure in terms of people and offices to audit these banks on its own.

Sound Corporate Governance Practices

As mentioned above, supervisors have a keen interest in determining that banks have sound corporate governance. The following discussion draws on supervisory experience with corporate with corporate governance problems at banking organizations and suggests the types of practices that could help to avoid such problems. These practices should be viewed as critical elements of any corporate governance process as are provided hereunder:

Establishing strategic objectives and a set of corporate values that are communicated throughout the organization:

It is difficult to conduct the activities of an organization when there are no strategic objectives or guiding corporate values. Therefore, the board should establish the strategies that will direct the ongoing activities of the bank. It should also take the lead in establishing the “tone at the top” and approving corporate values for itself, senior management and other employees.

The values should recognize the critical importance of having timely and frank discussions of problems. In particular, it is important that the values prohibit corruption and bribery in corporate activities, both in internal dealings and external transactions.

The board of directors should ensure that senior management implements policies that prohibit (or strictly limit) activities and relationships that diminish the quality of corporate governance such as:

- Conflicts of interest;
- Lending to offices and employees and other forms of self-dealing (e.g. internal lending should be limited to lending consistent with market terms and to certain types of loans, and reports of insider lending should be provided to the board, and be subject to review by internal and external auditors); and
- providing preferential treatment to related parties and other favored entities (e.g., lending on highly favorable terms, covering trading losses, waiving commissions).

Processes should be established that allow the board to monitor compliance with these policies and ensure that deviations are reported to an appropriate level of management.

Setting and enforcing clear lines of responsibility and accountability throughout the organization:

Effective boards of directors clearly define the authorities and key responsibilities for themselves, as well as senior management. They also recognize that unspecified lines of accountability or confusing, multiple lines of responsibility may exacerbate a problem through slow or diluted responses.

Senior management is responsible for creating an accountability hierarchy for the staff, but must be cognizant of the fact that they are ultimately responsible to the board for the performance of the bank.

Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns:

The board of directors is ultimately responsible for the operations and financial soundness of the bank. The board of directors must receive on timely basis sufficient information to judge the performance of management. An effective number of board members should be capable of exercising judgment, independent of the views of management, large shareholders or governments. Including on the board qualified directors that are not members of the bank's management, or having a supervisory board or board of auditors separate from a management board, can enhance independence and objectivity. Moreover, such members can bring new perspectives from other business that may improve the strategic direction given to management, such as insight into local conditions. Qualified external directors can also become significant sources of management expertise in times of corporate stress. The board of directors should periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective actions.

Boards of directors add strength to the corporate governance of a bank when they:

- Understand their oversight role and their "duty of loyalty" to the bank and its shareholders;
- Serve as a "checks and balances" function vis-à-vis the day-to-day management of the bank;
- Feel empowered to question management and are comfortable insisting upon straight forward explanations from management;
- Recommend sound practices gleaned from other situations;
- Provide dispassionate advice and are not overextended;
- Avoid conflicts of interest in their activities with, and commitments to, other organizations;
- Meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives;
- Absent themselves from decisions when they are incapable of providing objective advice;
- Do not participate in day-to-day management of the bank and prefer to oversee such routine activities by keeping broader focus on strategic issues.

In a number of countries, bank boards have found it beneficial to establish certain specialized committees including:

- *A Risk management committee* - providing oversight of the senior management's activities in managing credit, market, liquidity, operational, legal and other risks of the bank, (This role should include receiving from senior management periodic information on risk exposures and risk management activities).
- *An Audit committee* - providing oversight of the bank's internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non- compliance with policies, laws and regulations, and other problems identified by auditors, The independence of this committee can be enhanced when it is comprised of external board members that have banking or financial expertise.
- *A Compensation committee* - providing oversight of remuneration of senior management and other key personnel and ensuring that compensation is consistent with the bank's culture, objectives, strategy and control environment.
- A Nominations committee - providing important assessment of board effectiveness and directing the process of renewing and replacing board members.

Ensuring that there is appropriate oversight by senior management:

Senior management is a key component of corporate governance. While the board of directors provides checks and balances to senior managers, similarly, senior managers should assume that oversight role with respect to line managers in specific business areas and activities. Even in very small banks, more than one person ("four eyes principle") should make key management decisions, Management situations to be avoided include:

- **Senior managers who are overly involved in business line decision-making;**
- **Senior managers who are assigned an area to manage without the necessary prerequisite skills or knowledge;**
- **Senior managers who are unwilling to exercise control over successful, key employees (such as traders) for fear of losing them**

Senior management consists of a core group of officers responsible for the bank. This group should include such individuals as the chief financial officer, division heads and the chief auditor. These individuals must have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individuals in these areas.

Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide:

The role of auditors is vital to the corporate governance process. The effectiveness" of the board and senior management can be enhanced by:

(1) Recognising the importance of the audit process and communicating this importance throughout the bank;
(2) Taking measures that enhance the independence and stature of auditors;
(3) Utilising, in a timely and effective manner, the findings of auditors;
(4) Ensuring the independence of the head auditor through his reporting to the board or the board's audit committee;
(5) Engaging external auditors to judge the effectiveness of internal controls; and
(6) Requiring timely correction by management of problems identified by auditors.

The board should recognize and acknowledge that the internal and external auditors are their critically important agents. In particular, the board should utilize the work of the auditors as an independent check on the information received from management on the operations and performance of the bank.

Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment:

Failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to short or long-term risk con- sequences, This can be seen particularly with traders and loan officers, but can also adversely affect the performance of other support staff.

The board of directors should approve the compensation of members of senior management and other key personnel and ensure that such compensation is consistent with the bank's culture, objectives, strategy and control environment. This will help to ensure that senior managers and other key personnel will be motivated to act in the best interests of the bank. In order to avoid incentives being created for excessive risk-taking, the salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance, such as short-term trading gains,

Conducting corporate governance in a transparent manner:

As set out in the Basel Committee's paper Enhancing Bank Transparency, it is difficult to hold the board of directors and senior management properly accountable for their actions and performance when there is a lack of transparency.

This happens in situations where the stakeholders, market participants and public do not receive sufficient information on the structure and objectives of the bank with which to judge the effectiveness of the board and senior management in governing the bank.

Transparency can reinforce sound corporate governance. Therefore, public disclosure is desirable in the following areas:

- Board structure (size, membership, qualifications and committees).
- Senior management structure (responsibilities, reporting lines, qualifications and experience);

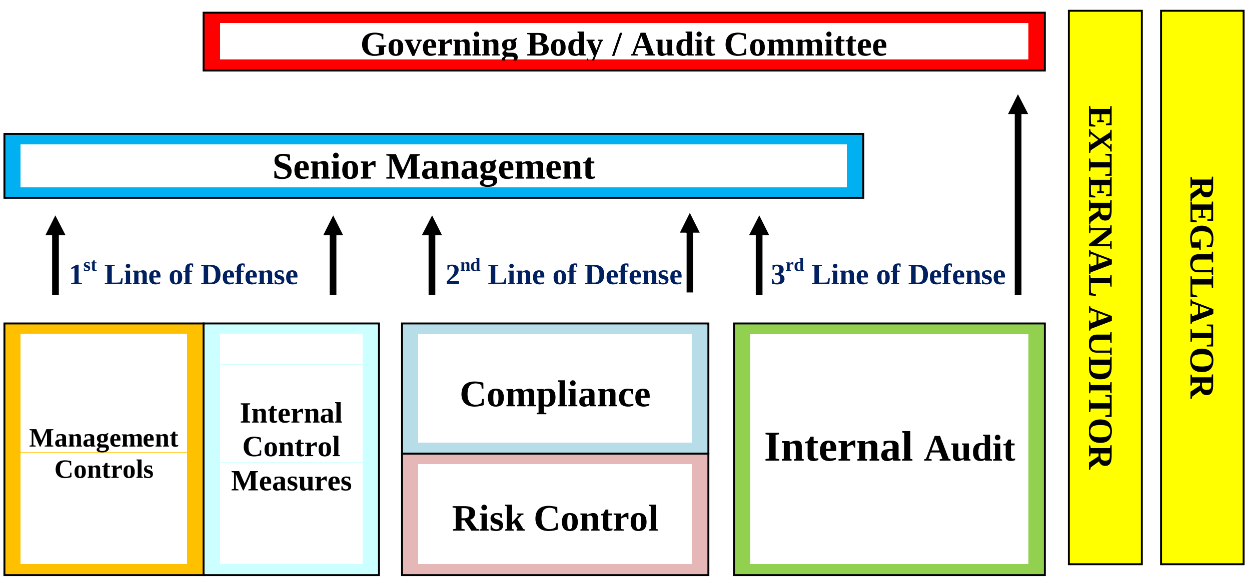
- Basic organizational structure (line of business structure, legal entity structure);
- Information about the incentive structure of the bank (remuneration policies, executive compensation, bonuses, stock options);
- Nature and extent of transactions with affiliates and related parties.

Summary

To sum up it is suggested that the banking and financial system in India will have to take up the word ‘Corporate Governance’ critically as the same can have very positive impact in curbing or mitigating the risk attached in the system. It is further advised that Banks in India in addition to implementation of what is suggested hereinabove can also consider the guidelines issued by the European Banking Authority (EBA) and the Basel Committee as under:

The ‘three-line-of-defence’ model as a new standard

Intensive scrutiny over governance arrangements is a clearly observed trend in the supervisory approach adopted by regulators all over the world especially in Europe. In terms of organisational structure, the provisions set out for setting the ‘three lines of defence’ risk governance model as provided hereunder can be considered as a standard.



1ST Line of Defense

Operational units take or acquire risk under a predefined policy and set of limits and perform daily checks, together with the regular monitoring, performed by authorized management on the activities and functions of which they have direct responsibility.

2nd line of Defense

Compliance and risk control develop, implement and maintain on an ongoing basis risk frameworks and objectively challenge execution of risk and compliance strategies, approaches and related management information.

3rd line of Defense

Internal audit function performs an independent, objective and critical assessment of the design and effectiveness of the overall system of internal control including 2nd line of defense functions. It is fully independent from audited areas and reports directly to governing body.

Risk Governance Model

'Fit and proper' management body and key function holders

Three major criteria are proposed: Reputation, Experience and Governance. In particular, regarding experience, both theoretical and practical experiences are required to be considered with a specific focus on specific domains of experience viz. financial markets, regulatory framework, strategic planning, risk management, internal control and financial information.

These strengthened criteria highlights the necessity to share a thorough understanding of key financial, risk and strategic information within the management body in order to effectively conduct the activities of the institution. A particular attention is made on technical knowledge of the banking business.

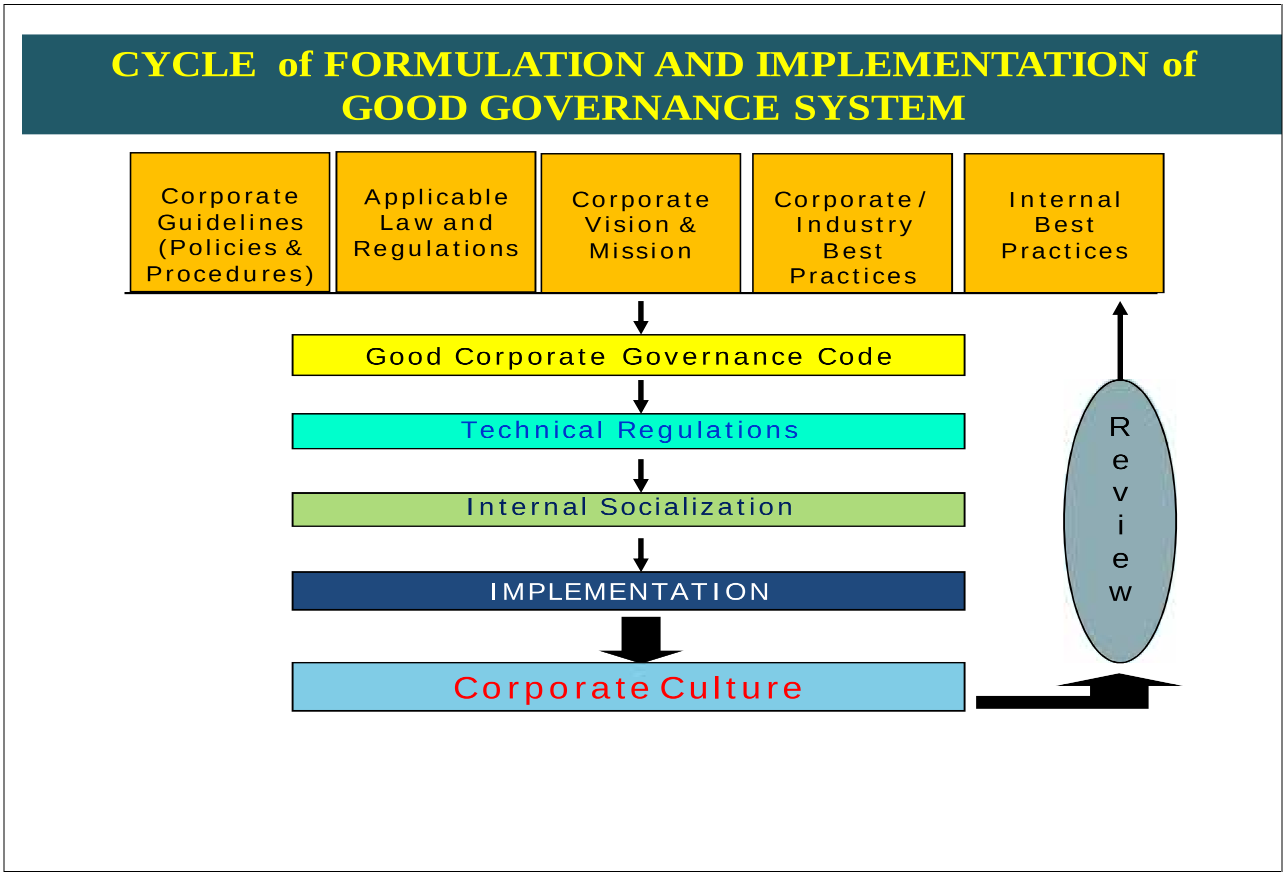
Increase requirements regarding risk management

Some of the key new requirements relate to risk management; both from an organizational and methodological point of view are as under:

- Creation of Chief Risk Officer (CRO) position as a member of the top management.
- An additional report should be prepared by the risk control function that highlights the shortfalls in relation to the existing required parameters.

In addition to above a model in line with as suggested by the Deloitte governance framework as provided hereunder can be taken up by the banks in order to bring effectiveness in the overall governance system:

Good Governance Framework Circle



In addition to above models, further steps are also required which can be taken up for ensuring best corporate governance system, like:

- Enhanced training to educate members of the governing bodies on their roles and responsibilities;
- Benchmarking the governance framework against regulatory requirements and peers;
- Enhancing the efficiency of the internal corporate governance through revision of the segregation of duties among control functions;
- Ensuring adequate risk management system, commensurate with the needs to match regulators' expectations;
- Having a robust completeness of the documentation hierarchy which includes strategies, policies, procedures and regulatory reporting and continuous review of the same;
- Necessary steps required to make audit committee and internal audit system very strong with complete independency and in line with changed regulatory norms as applicable to them.

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