CORPORATE GOVERNANCE IN THE BANKING SECTOR[1]

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Corporate Governance for the banking sector should be viewed in the overall context of the Governance structure of a country. Therefore, to expect that 'one shoe fits all' model for all the South Asian Countries would be unrealistic. In countries where capital markets are edging out banking or non-banking financial institutions such as Microfinance banks are nibbling away the market share the standards and norms applicable to banks should be equally applied to other financial sector players. To stringent standards for the banks and too lax for shadow banking have brought grief in the past and would remain a recipe for disaster for the health of financial system in the future. The recent example of default by a financing firm Infrastructure Leasing and Financial Services (IL&FS) in India had a ripple effect on the behavior of the whole financial sector .Strong recourse to Risk aversion led to a credit squeeze, freeze in some cases which in turn, has slowed down Indian economy recording one of the lowest growth rates in the recent history of India.

RBI has correctly observed that solvency contagion loss to the banking system due to idiosyncratic HFC / NBFC failure show that the failure of largest such institutions can cause losses comparable to those caused by the big banks.

It is therefore obvious that sound corporate governance in the banking sector alone is no guarantee that the contagion effect can be curbed from spreading its toxic effects throughout the financial system but also affecting the real economy.

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Having made this point, I would now turn my attention to the banking sector. Why is that Corporate governance is so critical for banking?

Before I touch on this important aspect, let us also first agree on the social purpose for which the banks exist-yes, they do operate to maximize value for the shareholders, adequately remunerate savings of depositors and allocate the savings for productive investment. These are the means-all laudable and necessary-but what do this all lead to. In my view, given the fact that South Asia has the largest proportion of the poor in the world --more than half a billion people---, has stark inequalities and disparities of income, gender, urban-rural ,the Banking sector has to extend its outreach to the majority of the economically active households. The main beneficiaries of the Banking business are the Government, State owned enterprises and corporate sector. Small farmers, SMEs, mortgage financing for affordable housing remain at the margin. India has a target of 40 percent for priority sectors to enhance credit flow to these vulnerable sections of the society which despite being credit worthy may not get timely and adequate amount of credit. The pre-requisite here is that the borrower should be credit worthy. Most of the poor householders fail to meet this criterion. Financial inclusion is therefore the social purpose which the banks should all strive to achieve.

Good governance has become buzz word throughout the world today but the imperatives of good governance in the banking industry are more compelling. The standards should be more stringent and strict. The ownership and management of the banking institutions should be passed on only to those who meet these though standards. There are some additional reasons that are unique to the banking sector which necessitate attention to this issue. These are:

• The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems.

- The failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.
- The performance of public sector banks in South Asia has been sub optimal resulting in large non performing loans due to politically motivated lending , recapitalization by the governments and poor service to the customers. Government dominated boards do not pay much heed either to the standards of corporate governance or to the regulators
- Private sector banks are motivated by profit maximization and their own financial stakes are limited and relatively low and they are therefore prone to excessive risk taking with the depositors' money. Some banks operate as part of industrial conglomerates . The Boards have to ensure that large shareholders nor management abuse their power and that decisions are taken with the Bank's best interests in mind.

Banking unlike other businesses is based on trust. Millions of small depositors have entrusted all their savings in the hands of the Bankers. The owners of the banks or manager's shareholders have limited stakes. The equity capital of the banking system ranges around ten percent of the balance sheet while ninety percent is derived from the depositor's money. So far each one rupee lost by the shareholder in case of the systemic crises, the depositors will lose nine rupees. Even then they have chosen to entrust this amount in the custody of the banks. Banks are therefore a trustee on "Ameen" and the fiduciary and moral duties of trustee are so well known obvious that they need not be repeated here. The corporate governance structure should align the interests of the management with the depositors as well as the shareholders. AS the management possesses asymmetric information that is not available to the depositors or equity holders ,integrity is the highest value that out to be practiced by the banking professionals without any semblance or perception of compromise. Ostentatious life styles of bankers do not get unnoticed or commented upon. Violation of professional ethics is something which the bankers are responsible and accountable . The foremost consideration for a robust corporate governance structure is therefore to have zero tolerance for those who lack integrity. Those who are found guilty of indulgence in corruption should be removed forthwith.

How do banks therefore position themselves to achieve these standards of governance. Let us be quite clear : The responsibility for good corporate governance is shared responsibility divided among the management, board, regulators acting as lines of defence against recurrence of crises and panics and for avoiding contagion effects to seep through the system.

The first line of defence is the management of the banks, the second is the Board of Directors, the third is the self regulatory body of the banks and the final line is the banking regulator. If the water is allowed to seep in or cross the earlier lines of defence the task of the regulator becomes more difficult and onerous because the intensity becomes fiercer. Thus, if the bank management, Boards of Directors and self regulatory body perform their task well and defend their respective barriers by reporting all infractions, violations, lapses, deviations and slippages to the regulator well in time, the damage can be controlled. Misrepresentation and concealment of material facts from the regulator should attract worst kind of sanctions and penalties including the suspension from the profession. But this will happen only when the values of courage, openness, accountability and responsibility are internalized.

Cooperation with regulators and self regulation are the means through which the core values I have spelled out above can be harnessed. Regulators believe that they have done away with the culture of fear, suspicion and mistrust, that they have adopted a more collaborative and participative approach, that they do listen to the industry and stakeholders but this does not absolve them from their fundamental task. The task is to safeguard the depositors' interests, avoid recurrence of systemic crisis and keep the financial markets functioning and stable.

While the competitive environment in the banking industry has taken a turn for better it has also given some cause for concerns. When the main preoccupation revolves around bottom line result, capturing market shares, attracting new deposits and businesses and incentives such as performance bonuses, stock options, exceptional merit increases are dangled there are pressures to make compromises, cut corners and adopt ethically questionable means. There would be dazzling temptations .It is for the Board members to keep their eyes and ears open and use market intelligence, media reports, audit reports to periodically keep themselves informed and alert and take actions against those found indulging in unethical practices. After all, they are the custodian of the trust reposed by shareholders and depositors.

Some Directors interpret their role too narrowly and succumb to the temptation to micro manage, get deeply involved in operational issues and second guess the management. To them, they are fulfilling the requirements of their fiduciary responsibilities. This is stretching the mandate of the Board too far blurring the distinction between, oversight and actual delivery. This tendency should be resisted. In other cases, the Board members assume that they have selected the right man for the Chief Executive's job so he/she should be given free hand to carry out his functions. This unconstrained trust in an individual without questioning or probing or getting the requisite information can lead to surprises and unforeseen adverse consequences. The Board members should also avoid following in this trap of excessive trust.

In between these two extreme positions there is a middle way in which the Board can discharge its obligations effectively.

Increased economic volatility that has now become quite common should prompt the Directors to rethink the strategic thrust by asking fundamental question: whether the continuation of the existing business model would equip the banks to face the new challenges. Whether full blown restructuring and transformation or spin offs or closure of some business segments would become necessary. Board members should help management to broaden its thinking by considering new even unexpected perspectives and to inquire whether the specific capabilities, skills and resources the bank possesses are adequate to produce returns under different strategic options. The management should be asked to Update organizational priorities in light of the likely changes in the external environment. For example, anti-money laundering and terrorist financing have become a major area of concern for the regulators as well as international policy makers. The regulators and supervisors have prescribed the rules to deal with this problem. But it is the responsibility of the boards to ensure that these rules are being complied, internal monitoring mechanisms are in place, data is being exchanged with the authorities, responsibilities and accountabilities are clearly lad out.

Another challenge that may be facing sooner or later is the emergence of Fin techs, Peer to Peer lending, alternate payment systems, shadow banking and other innovative practices that would create disruption of the existing business model followed by the banks. The Board has to take the lead by asking the question from time to time as to how the management is positioning itself to meet these existential challenges. Do they have credible action plans whereby they don't lose their focus from the existing business but at the same time develop transition plans for entering new businesses.

To conclude, the banking sector in South Asia has to evolve corporate governance standards not simply as a compliance exercise but as an integral part of its strategy and business plans. Strategy and organizational goals have to be continuously reviewed and updated. Capabilities, skills and resources to meet the new challenges have to be realigned . The Boards have to keep a vigilant eye to ensure that the bank management is adapting itself to the on coming challenges particularly by marrying financial inclusion with financial stability while providing adequate returns to the depositors as well as equity holders.

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