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The Pertinent Issues of Corporate Governance in Banks

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Abstract

Business ethics is the study of morals and moral choices which focus on standards, rules and codes of conduct that govern the behavior of individuals and groups. Business ethics are an integral constituent of corporate governance. Corporate governance is the aggregate of conventions, procedures, regulations, and policies, which guide the way a firm is directed and controlled. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy its shareholders, creditors, employees, customers and suppliers. The corporate governance is the efficient use of resources and equally accountability for the stewardship of those resources. Gabrielle o' Donovan defines corporate governance as "an integral system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity and integrity". Its aim is to align as nearly as possible the interests of individuals' corporations and society. In this article the emphasis is on the role of corporate governance in banks as they are the critical infrastructure component in an economy.

Introduction

Business ethics is defined as a process for integrating values such as honesty, trust, transparency and fairness into its policies, practices and decision making. Business ethics is therefore inherently linked with corporate governance. The corporate governance structures specify the distribution of rights and responsibilities among different participants in the corporation such as the board, managers, shareholders and other stakeholders. It explains the rules and procedures for making strategic decisions on corporate affairs by providing the structure through which the company objectives are set and monitored". Corporate governance is concerned with the intrinsic nature, purpose, integrity and identity of the institution with a primary focus on the entity's relevance continuity and judiciary aspect.

Cadbury (2000) defined "corporate governance as being concerned with holding the balance between economic and social goals and between individual and communal goals."

The major elements of corporate governance are good board practices, control environment, transparent disclosure, well defined shareholder rights and board commitment. The four pillars of corporate governance are accountability, fairness, transparency and independency (Omeiza- Micheal, 2009).

The evolution of corporate governance is from two reasons: 1) the shareholders (owners) delegate decision making rights to managers to act on their behalf as there is a separation of ownership from management which implies a loss of effective control by shareholders over managerial decisions. 2) It is not efficient for (most) individual shareholders to monitor the company on their own. Thus, the primary objective of corporate governance is to attempt an alignment of the managerial incentives with those of stakeholders. This is to check the tendency of selfishness by managerial employees especially the top ones to ensure that delegated decisions making powers are not abused to the detriment of shareholders and other stakeholders. **Figure I**

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Committee on Corporate Governance from Indian perspective

There are various committees formed with a view to reforming the Corporate Governance in India since 1990s. Some of the recommendations of these committees are highlighted below.

- Confederation of Indian Industries (CII) set up a task force in 1995 under Rahul Bajaj, a reputed industrialist. In 1998, the CII released the code called "Desirable Corporate Governance". It looked into various aspects of Corporate Governance and was first to criticize nominee directors and suggested the role of government in companies.
- The SEBI established a committee under Kumarmanlagam Birla which covered issues relating to protection of investor interest, promotion of transparency, building international standards in terms of disclosure of information.
- The Department of Companies Affairs (DCA) modified the Companies Act, 1956 and brings amendments in it. In 1999, the Act facilitates the nomination of shareholders and share buybacks and for formation of investor education and protection fund.
- The DCA constituted a committee under Naresh Chandra in 2002. The committee talks extensively about the statuary auditor-company relationship, rotation of statutory audit firms/partners, procedure for appointment of auditors and determination of audit fees, true and fair statement of financial affairs of companies.
- SEBI appointed Narayan Murthy Committee in 2002. The committee makes mandatory recommendations regarding responsibilities of audit committee, quality of financial disclosure, requiring boards to assess and disclose business risks in the company's annual reports.

OECD -Organization for Economic co-operation and Development from Global Perspective

The OECD is the best guide to global corporate governance and an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. It provides specific guidance for legislative and regulatory initiatives in both OECD and non OECD countries. The OECD (1999) gives following principles of corporate governance:

- The rights of shareholders should be protected.
- There should be equitable treatment of shareholders including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- The role of stakeholders should be recognized as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.
- There should be timely and accurate disclosure on all material matters regarding the corporation including the financial situation, performance, ownership and governance of the company.
- The framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the boards accountability to the company and the shareholders

Corporate Governance in Banking Sector

Banks are the backbone of the global economy, providing capital for innovation, infrastructure, and job creation and overall prosperity. Banks also play an integral role in society, affecting not only spending by individual consumers, but also the growth of entire industries. So, corporate governance in banks is a major requirement for present scenario. The concern over corporate governance stems from the fact that sound governance practices by organizations, banks inclusive results in higher firm's market value, lower cost of funds and higher profitability (Block, Jang & Kim, 2006 & Claessen, 2006).

According to Imala (2002) and Srivastava (2010) from the perspective of the banking sector, corporate

governance involves the manner in which the business and affairs of individual institutions are governed by their board of directors and senior management with depositors standing out clearly as the most important stakeholder. Good corporate governance leads to development of a framework that provides adequate protection to the interests of stakeholders and their responsibilities. With the globalization of markets, international capital flows have become extremely valuable source of external financing. It is essential for companies to observe good corporate governance standards in order to competitively operate in the global capital market and to attract long-term foreign capital.

Shleifer and Vishny (1997) define corporate governance 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.

In the banking sector corporate governance is therefore a way of business and affairs of the bank by the management and the board, affecting how (BCBS, 2006, February):

- To define the objectives and goals;
- To identify lead current bank activities;
- To fulfill the obligation of accountability to shareholders and take into account the interests of stakeholders;
- To apply the requirement to operate safely and to ensure a good financial situation and compliance with applicable regulations;
- To protect the interests of depositors (and other clients and creditors).
- Define the role, tasks and responsibilities of the board, as well as its size, organization and composition (members) and the functioning of this body and the assessment of its work;
- How to control of bank risk exposure;
- Evaluation of executives and its incentive pay;
- Transparency of the bank supervisory board that allows for the assessment of its activities (both by institutional and private monitoring);
- Define ownership structure of banks and the role of institutional investors.

Principles of Corporate Governance in Banks

- Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
- The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization.
- The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization.
- The board should ensure that there is appropriate oversight by senior management consistent with board policy.
- The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions.
- The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.

Need for Corporate Governance in Banks:

- Corporate governance in banks is different from the standard (typical for other companies), which is due to several reasons.
- Banks are subject to special regulations and supervision by state agencies, purchasers of securities issued by banks and depositors.
- Banks are part of society due to bankruptcy of a bank raises social costs, which does not happen in the case of other kinds of entities' collapse which affects the behavior of other banks and regulators.
- Due to regulations and measures of safety net substantially the behavior of owners, managers and customers of the banks changes so that rules can be

counterproductive, leading to undesirable behavior management (take increased risk) which expose well-being of stakeholders of the bank (in particular the depositors and owners).

- There are fiduciary relationships between the bank and its clients which raise additional relationships and agency costs;
- Due to the asymmetry of information not only between owners and managers, but also between owners, borrowers, depositors, managers and supervisors it is needed.
- The governance of financial institutions is more complicated due to number of parties as a stakeholder in an institution.

Failure of Corporate Governance in Banks

- Negligence of control by the regulatory authorities, corruptions, inactive boards and greed on the part of the executives.
- The inability of the board of directors to effectively supervise top management of these banks has contributed more to this repulsive situation.
- Most members of the board of these banks were unilaterally nominated by the managing director or the chairman who holds controlling interest in the bank as the suppliers of capital.
- To this end, board members have no financial contributions to the bank as they were in order to comply with statutory requirements, therefore it is imperative for them to rubber stamp all decisions of their beneficial as they are friends or business associates.

Mechanisms of Corporate Governance in Banks

The need for in-depth analysis in banks and financial markets is due to irregularities that led to the financial crisis of all aspects of their operation, in particular the efficiency of corporate governance. The result was an indication of a number of shortcomings; sometimes they resulted from inadequacy or insufficiency of the provisions, other times from human imperfections. To strengthen and repair the system in banking sector, regulatory and supervisory institutions and environmental bodies prepare proposals for reforms to strengthen the mechanisms of corporate governance are as follows:

- Banks should reduce their risk exposure significantly and build a stronger capital base.
- Banks should concentrate on typical banking activities and reduce the scale of other operations (especially investment activities).
- The good standards of balance-sheet adequacy (ALM) should be restored (e.g. loans-deposits relationship, assets and liabilities maturity match, leverage scale, etc.).
- The current level of financialization is excessive and potentially dangerous for the whole economy therefore the scale and scope of banking activities should be diminished.
- Special attention should be paid to systemic risk as the capital and contractual relationships between financial institutions should be monitored and if the linkages would become too strong and/or concentrated; supervisors should be allowed to interfere in these relationships.
- Both executive and non-executive should bear personal responsibility for banks' activities and risk.
- Banks' executives' remuneration should be linked to performance and risk exposure and there should be an obligation to use part of their salary deferred: a) not to motivate to generate short-term profits and increase the risk and b) make the bonuses contingent on long-term sustainable outcomes.
- Non-executive directors engagement should be stronger – they should devote more time and commitment to perform their oversight function. The nomination of supervisory board members should be approved by the supervisors (as it is in case of management board members) and the role of independent board members should be strengthened, board members should be required to have proper knowledge and experience (including the financial expertise).

- Banks' transparency should be strengthen by regulators and market supervisors allowing for the effective market discipline and professional bodies should promote best practice in disclosure and motivate banks to publish more informative reports.
- The accountability of external and internal auditors should be stronger and they should be obliged to report any observed non-compliance to supervisors. The auditors should be subject to mandatory rotation and should be banned from performing services for one client of other services beyond the audit of financial statements.
- Financial market should strengthen the "comply or explain" rule used in corporate governance area, being a sort of a "soft law" should and the supervisor should verify whether the disclosed information is reliable and sufficient.
- in particularly important areas in which banks persistently do not comply with corporate governance best practices, supervision should make formally binding rules; one should keep in mind, however, that this should not lead to excessive growth of regulation because it would harm the competition (overly restrictive regulation can lead to inefficient provision or supply of financial services).

Conclusion

It is unrealistic to expect that the supervision and private monitoring of complex financial markets and institutions may be based solely on regulations, but this neither means that the state may exempt from these processes. An effective regulatory regime must be based on a desire to keep high management standards and values as part of banks' corporate culture (R. Tomasic, 2011).

In end, the greatest responsibility for the excessive risks is borne by the banks themselves – their management and supervisory directors. It is essential for other stakeholders also contributed to the crisis: supervisors and regulators, participants in financial markets (including investors), auditors and rating agencies, and clients. As we know legal, economic and ethical issues differentiate the degree of responsibility and accountability of the effects of the acts. So it is necessary to emphasize the importance of accountability of all banks' stakeholders. There are no perfect regulations, and legal standards to ensure success. This is because it is the attitude and positive valuable actions of human beings; honesty and sense of responsibility of all stakeholders of the bank are necessary. As it is nowadays emphasized, there is also no doubt that the basic element of the improved governance of the financial market should be ethics (EC, 2010).

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Figure I : Players in Corporate Governance