Gist of EPW August Week 3, 2020

RBI Moves to Shake Up Governance at Banks

Context:

- RBI has come up with a discussion paper namely "Governance in Commercial Banks in India" in which the approach to governance is taken as ownership-neutral.
- It also highlights that the private sector banks are not at all free from the flaws in governance just like the public sector banks.
- This article analyses the possible solution to reduce these shortcomings in the banking sector.

Background:

- Since three decades, the status of Corporate governance has been work in progress and this sluggish improvement may cost a lot to the banking sector.
- The Global Financial Crisis of 2007 has not only highlighted the shortcomings of banks but also paved way for various banking reforms along with the governance reforms across the world.

Nayak Committee recommendations:

- In 2014, the P J Nayak Committee on governance reforms was appointed by the Reserve Bank of India (RBI).
- The report of the committee emphasized particularly on the Public Sector Banks (PSBs) and provided the following recommendations:
    - The committee assumed that the major problem of the government lies with the public sector and hence, the possible solution will be the transfer of ownership of banks from the public sector to the private sector.
    - Privatization of the banking sector will lead to the adoption of a market-based compensation pattern, which will free the government from appointing a board of directors and managers, etc.
    - If the government did not resort to privatization then, imitating the functioning of private sector banks will be another best option.

Concerns:

- However, recent happenings in private sector banks have raised doubts over the assumption of the Nayak Committee report that major problems in the banking sector lie with PSBs only.
- Even in private sector banks, governance is lacking in many aspects. There have been noisy exit of a CEO of private sector bank and failure of private sector bank as well.
- It can be established that governance is not the differentiating factor that has led to better performance of private sector banks as compared to PSBs.

Discussion Paper by RBI

- The Reserve Bank of India in its discussion paper named "Governance in Commercial Banks in India" does not make any demarcation in its wide approach between PSBs and Private banks.
- It is clear from the recommendations of the paper that the problems of governance in the banking sector go beyond the ownership classifications.
- The paper initially discusses the responsibilities of the board of directors of a bank which are summarized below:

- To appoint the full-time directors, the CEO, and other senior officers.
    - To monitor their work performance.
    - To determine their compensation, and
    - Planning for succession.
- However, there is no clarity on whether or not the board performs all the functions mentioned above, except for the monitoring of work performance.
- The paper clearly states that RBI has no intention to vest these functions with the board in case of PSBs. There will be the continuation of a dual regulatory system (Shared responsibility by RBI and the government) with respect to the PSBs.
    - The government is the major stakeholder of PSBs and it takes all the important decisions regarding the major functions of the banks.
- The recommendations for appointments are made by the Banks Board Bureau (BBB) and the ministry of finance finalizes the decisions.
    - Instead of taking these decisions from outside the board, the government should exercise these functions through its nominees in concerned boards.
    - By doing so, the boards of PSBs will be empowered and it must be the beginning of the governance reforms at PSBs.
    - It would have been useful if the RBI had used the paper to strongly advocate such a course.

New Ideas proposed in the discussion paper by RBI:

The paper by RBI has presented two groundbreaking ideas:

1. Limiting the terms of CEOs and whole-time directors.
2. Insulating key management functionaries from the CEO.

Limiting the terms of CEOs and whole-time directors:

- The paper proposes a 10-year term for promoter-CEOs and whole-time directors and a 15-year term for a management professional who is not a promoter.
- The paper also suggests a two years' timeline for an orderly succession for those who have completed 10 or 15 years at the time when the guidelines will come into force.
- However, many believe that the board should decide the tenures of CEOs and whole-time directors.
- The issue of longer tenure is related to private banks rather than PSBs as CEOs in PSBs usually have short terms.
- It is not right to leave the decision over fixing the tenure of the CEO to the board as the promoter of the bank has considerable influence in appointing board members.
- Even removing a professional CEO is difficult as CEO also has a considerable influence in shaping the overall composition of the board. Hence, unless there is a crisis or the performance of the CEO is disastrous, it is nearly impossible for the board to remove the CEO.
- The proposal of limiting the tenure of CEOs thus should be seen as addressing market failure in the realm of CEO succession.

Insulating key management functionaries from the CEO:

- The paper proposes that four key management functionaries Chief Risk Officer (CRO), Chief Compliance Officer (CCO), Head of Internal Audit (HIA), and Chief of Internal Vigilance (CIV) should be insulated from CEO.
- CRO and COO should be answerable to the risk management committee of the board.
- HIA and CIV should be under the supervision of the Audit Committee of the board.
- These committees will decide the selection, oversight, appraisal, and removal of these four functionaries.

- Apart from these four functionaries, RBI's paper proposes that the company secretary should report to the chairman of the board, and the nomination and remuneration committee of the board should assess his/her performance.
- These proposals will dilute the powers of the CEO as these functionaries will function nearly independently of the CEO. At the same time, it will increase the responsibilities of the board.
- According to RBI, such arrangements are necessary for the effective performance of these functionaries.
- Though, the argument has merits of its own, depriving the CEO of having control over them may not be the answer. Though CEO dominated board is an issue, reducing the CEO to a cipher is also not desirable.

Way Forward - Modification required in RBI's proposal:

- The CEO can make recommendations over the appointment and appraisal of these functionaries to the board. The boards would have the final say in appointment and appraisal.
- At the same time, the removal of these functionaries should be the prerogative of the board.
- The paper proposes that the Risk Management Committee (RMC) of the board should have only non-executive directors. However, the CEO and other full-time directors have an overall idea about the risk associated with the banks. They should also have a say in RMC.
- The paper does not mention anything about the remuneration of the board members. This should have been specified, as appropriate compensation is necessary to attract people with the necessary skills and commitment.

The report of the Parliamentary Commission on Banking Standards in the United Kingdom (2013):

- The discussion paper of the RBI has put up a roadmap for radical reforms in the banking sector.
- Apart from other sources, RBI can also look into the report of the Parliamentary Commission on Banking Standards in the United Kingdom (2013), for more useful insights in banking sector governance.
- The report has mentioned several reforms such as:
    - Spelling out in detail, the responsibilities of senior management persons so as to fix accountability.
    - Putting an advertisement for the position of independent directors for banks above a certain size.
    - Review of the performance of chairman of the board by a senior independent director.
    - Disclosure of methods which are used in fixing the remuneration of executives in annual reports.

Conclusion:

Banking governance requires comprehensive reforms. The discussion paper put forward by RBI is a welcome move in this regard. The reforms must be independent of the ownership status of banks i.e whether the bank is PSB or privately owned.