ISSN- 0976- 495X www.anvpublication.org

www.anvpublication.org

RESEARCH ARTICLE

Corporate Governance: A Study on Indian Banking Sector

Dr. Suman Kalyan Chaudhury[1]*, Prof. Debi Prasad Mishra[2], Santanu Kumar Das[3]
[1]Faculty Member, P. G. Department of Business Administration, Berhampur University, Odisha
[2]Professor, P.G. Department of Business Administration, F.M. University, Balasore , Odisha
[3]Assistant Professor (MBA), Kalam Institute of Technology, Govinda Vihar, Berhampur, Ganjam, Odisha
*Corresponding Author E-mail: **sumankalyan72@gmail.com; dr_dp1958@yahoo.co.in; santanu.das.kumar@gmail.com**

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

ABSTRACT:
The thrust for greater transparency towards stakeholders of the business has led to the emergence of the concept of Corporate governance, which was a response to corporate failures and widespread dissatisfaction with the way many corporate function, has become one of the wide and deep discussions across the business sectors as a global phenomenon. The founding principles of corporate governance lays emphasis primarily hinges on complete transparency, integrity and accountability of the management. There is also an increasingly greater demand on investor interests and public orientation. Corporate governance is apprehensive with the values, vision and visibility. It's all about the value orientation of the firm, ethical norms for its performance, the direction of development and social accomplishment of the organization and the visibility of its performance and practices. This paper focuses on corporate governance issues in Indian banking sector in specific as banking sector deserves special attention, the sector is mainly responsible for the allocation financial resources to all other sector of any economy. While recent high profile corporate governance failures in developed country have brought the subject to media attention. Through this research article we have discussed about the corporate governance issues in the view of Basel and Birla committee recommendation in the last we also have discussed about the need and prerequisites for corporate governance in Indian banking system.

KEY WORDS: Corporate governance, India banking sector, corporate governance issues, Basel and Birla committee

INTRODUCTION:
Over the decades the term 'Corporate governance' has become one of the most common terms in development literature, business management, law, finance and economics. As Farrar (1998) noted, corporate governance is a fashionable concept but like most fashionable ideas it is remarkably imprecise as it covers a large number of distant economic, legal, philosophical, social and political phenomenon.

Given the variety of perspectives and approaches of corporate governance, different scholars, practitioners have come up with varied definitions that essentially reflect their special interest in the field. Some of them have a narrow, operational focus and equate corporate governance with (a) Working of board of directors, (b) Ensuring accountability of senior management, (c) Standards by which the corporation is to be governed and (d) Protection of shareholder's interests (e.g., Shleifer and Vishny, 1997; Farrar, 1998; Daily and Dalton, 1993). Similarly, broad definitions of corporate governance covers number of issues focused on the entire network of formal and informal relations in the corporate business organizations, and their consequences on society in general (eg., Sullivan, 1998; Dalton et al., 2003). One can understand the complex magnitude, scale, scope and difficulty for arriving at an all-encompassing definition of corporate governance, because

Received on 03.05.2013 Modified on 10.06.2013
Accepted on 18.06.2013
© A&V Publication all right reserved
Asian J. Management 4(4): October –December, 2013 page 260-268

of several contending views in the field of corporate governance, wherein some tend to be narrow and some much broader. Corporate governance therefore, reflects an interdisciplinary understanding and practice to safeguard the interests of shareholders, employees, customers, suppliers and community, etc.

"Corporate governance is about the way businesses are run to ensure that companies perform in responsible and responsive ways to the interests of its stakeholders" (Clarke,1993; Pimm, 1993).

A series of international corporate failures and financial scandals in the late 1980s, including BCCI, Polly Peck and Maxwell Communications, has heightened concerns about the standard of financial reporting and accountability.

The need for corporate governance, which emerged as a response to corporate failures and widespread dissatisfaction with the way many corporate function, has become one of the wide and deep discussions across the globe recently. It primarily hinges on complete transparency, integrity and accountability of the management. There is also an I ncreasingly greater focus on investor protection and public interest. Corporate governance is concerned with the values, vision and visibility. It is about the value orientation of the organization, ethical norms for its performance, the direction of development and social accomplishment of the organization and the visibility of its performance and practices.

REVIEW OF LITERATURE:

There are important facts regarding the importance of corporate governance of banking firms. According to Caprio, Leuven, and Levine (2003), governance mechanisms would be able to reduce the expropriation of bank resources and promote bank efficiency. The expropriations are inclusive of theft, transfer pricing, asset stripping, hiring family members, and credit allocation that enriches the bank insiders and hurt the bank.

The concept of efficiency can be viewed from the flow of funds in the form of debt or equity to the corporations producing goods and services in the most-efficient manner with the highest rate of return. The banking institutions have in fact been positively contributing to companies' performance (Eldomiaty and Choi, 2003).

In a developing economy such as India, the growth of efficient corporate governance principles in banks has been partly held back due to weak legal protection, poor disclosure prerequisites and overriding owners (Arun and Turner, 2002a). Moreover, the private banking sector is purposely opting to ignore certain corporate governance ethics as it has vested interest of some parties (Banaji and Mody, 2001).

In the western world banks in Germany as characterized by its ''Universal Banking System'' are more heavily involved in financing corporations as compared to capital markets thus the need to assume much larger role of corporate governance due to their position as lenders, share underwriters, major equity holders, stock exchange market maker, holder of corporate board positions and exercising proxy votes held by small shareholders (Lowengrub, Luedecke, and Melvin, 2003).

As major creditors to the corporation and in some countries as major equity holders, banks play a role in influencing the corporate governance of firms as well (Caprio et al., 2003). Chirinko, van Ees, Garrestsen, and Sterken (1999) argued that in a situation of large creditor ship where firms rely on credit from financial institutions, bank is able to play governance role by monitoring the firm activities, demand audits, and impose penalty payments. As such, sound governance of a bank increases the likelihood that bank will exert sound governance over the firms they fund. Corporate governance mechanisms in the banking industry are largely explained by the nature of the industry itself. First, there is a conflict between claimant and shareholders of a banking firm. Crespi, Garcia- Cestona, and Salas (2003) argued that there is a conflict between the shareholders' and depositors' interest. Shareholders are disposed to take high-risk projects that maximize the shareholders wealth at the expense of the value of the deposits. Such activity will not give benefits to the depositors even if the high-risks activity succeeds. In fact, they will suffer some portion of losses should the bank fail due to excessive risk-taking. In such situation, the regulation is needed to protect the depositors' interest. Macey and O'Hara (2003) argued that a broader view of corporate governance should be adopted in the case of banking institutions that include depositors as well as shareholders. Second, banks are operated with greater opaqueness since opaqueness is one of the special attributes of banks that require different treatment of its corporate governance (Levine, 2003).

The issue of opaqueness is related to information asymmetries, which is more pronounced in larger banks compared to non-financial firms. In a banking business, loan quality is not readily observable and can be hidden for long periods. On the other hand, banks can alter risk composition of their assets more quickly than most non-financial industries. Furthermore, banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. As the information is incommunicable, depositors do not know the true value of the bank's loan portfolio (Bhattacharyya and Rao, 2004). Those instances reveal the severe difficulties in acquiring information about bank behavior and monitoring the ongoing bank activities that hinder traditional corporate governance mechanisms . Third, banks have a unique capital structure as distinguished by its liabilities and equity. Berger, Herring, and Szego (1995) concluded that banks have the highest leverage as compared to other firms in any industry. Bank is characterized by heavy reliance on

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

debts that typically amounted to 90% of its total liabilities and equity. This is largely in the form of deposits which are available on demands. On the other hand, bank's assets take the form of loans and advances. Thus, bank is creating the liquidity for the economy through the holding of illiquid assets (loans) and issuing liquid liabilities (deposits). This situation allows for a bank run where the depositors rush to be among the first to withdraw their money before the bank's cash reserves are drained.

Levine (2003) further argued that government may improve the governance of the banking institutions by privatizing banks with substantial government ownership since heavy government involvement changes the corporate behavior of banking institutions. Nevertheless, it is also recommended that greater ability and incentive should be induced to the private investors to exert governance rather than relying heavily or excessively on government regulations. However, consistent with political view, government ownership is regarded to be detrimental as it may induce political intervention in the banking firm (Arun and Turner 2004). The extensive government ownership of banks that are mainly found in developing economies (La Porta et al., 2000) led to the governance problem of conflict between government/ taxpayers as owners and the bureaucrats/managers who control the bank. These include the acts of managers which are unfavourable to the owners in the issues of incentives, prerequisites, leisure time, staff numbers, undertake less risk than the optimal standard as well as using their position to serve special groups as a platform for political career. The above studies generally reached a consensus that there are indeed significant differences in corporate governance practices between banking firms and corporations in other economic sectors. The differences are attributed to the special nature of the banking institutions that warrants for broader view of corporate governance for banks compared to non-financial firms (Adams and Mehran, 2002, 2003; Levine, 2003; Macey and O'Hara, 2003).

The structural changes in the banking industry in the form of development of latest technologies, main industry consolidation, globalization, and deregulation have got the banking industry at a strategic junction. Hence, banks face a more competitive and volatile global environment than so called stereotype situation of management. The banking sector may be closely monitored by the public due to its nature of transactions and some bad precedents in the past. This sector is very sensitive as a small mistake can easily attract negative publicity. It is a part of corporate governance with most of its management obligations enclosed in regulatory regulations. In the light of the above statement governance issues in banks, more particularly in Public Sector Banks (PSBs), assume immense significance, but unfortunately these are less discussed and deliberated upon.

Coming to a developing country like India, all attributes of governance mechanism can be easily implemented due to many complexities involved in it.

OBJECTIVES OF THE STUDY:

The objective of this present paper is to know the new paradigm of the corporate governance practices all over the business, to point the indices of good governance, to examine the conjectural inputs of governance in banking sector and New out looks on governance, control and highlight the various issues and challenges in Indian banking sector

INDIAN BANKING SECTOR:

The Indian banking has around 200 years of history and has undergone many transformations since independence. As Banking system occupies an important place in a nation's economy, a banking institution is indispensable in a modern society. It plays a pivotal role in the economic development of a country and forms the core of the money market in an advanced country. Earlier, banking was virtually a monopoly of the public sector banks with complete protection from the state from the exigencies. But, Liberalization, Privatization and Globalization and the rapid information technology with virtual banking are currently changing the Indian Banking fundamentally. By the process of reforms in the Indian banking system has undergone a paradigm shift to more liberal and free market forces. Now the banks, more particularly the public sector ones, in midst of global competition. The sudden shift in the banking environment has bereaved the banks of all their comforts and many of them are finding it extremely difficult to cope with the challenges of changed enivironment. Globally, while banking operations have been undergoing drastic metamorphosis, financial stability has come to occupy the centre-stage as one of the primary policy concerns facing central banks worldwide. Given the predominantly bank – based nature of financial systems in emerging markets, there is growing realization that the preservation of the safety and soundness of individual financial institutions, especially banks, and of the financial system as a whole is important not only for conducting business across national borders, but also for preserving financial stability. Banking had traditionally remained a protected industry in many economies, especially emerging economies. Though the money market is still characterized by the existence of both the organized and the unorganized segments, institutions in the organized money market have grown significantly and are playing an increasingly important role. Indian Banking industry is unique in having more regulators than most other industries. In the economic development of a nation, banks occupy an important place. Banking institutions form an important part of the money market and are indispensable in a modern developing society. Indian money market comprises both organized as well as unorganized sectors. Banking System in India is dominated by nationalized banks. Prior to nationalization, banks in India with the sole exception of state bank of India were in private hands with community and trade orientation. Nationalization of 14 banks in the year 1969and another set of 6 banks in the year 1980 reduced the importance of private sector banks and public sector banks started playing a major role in extending the horizon of banking services to

the nook and corner of the country. Private Banks have been playing a crucial role in the enhancing customer oriented products with no choice left with the public sector bank except to innovate and compete in the process.

CORPORATE GOVERNANCE- A HISTORICAL BACKGROUND:

The most influential guidance on corporate governance comes from the Cadbury report. In May 1991 a committee on the "Financial Aspects of Corporate Governance" (the Cadbury Committee) was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession, under the chairmanship of Sir Adrian Cadbury. The overall objective of the Cadbury Committee was to improve standards of corporate governance by setting out clearly the respective responsibilities of directors and boards of directors to shareholders, management, regulators, auditors, and other stakeholders.

Corporate Governance as a concept conjures up different meanings and explanations. Corporate governance is a concept that envisages a set of systems and checks which ensures that the company is managed properly to the best interests of shareholders, creditors, employees, customers, suppliers, community and government to say the larger society. Corporate governance provides a firm foundation for the development of economies. A good corporate governance mechanism improves the health of the corporate sector, thus enhancing national competitiveness. The self-regulatory organizations of various countries have extensive experience in promoting corporate governance and creating a positive corporate governance culture

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets (predating the Tokyo Stock Exchange) with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures.24 In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies. The 1956 Companies Act as well as other laws governing the functioning of joint-stock companies and protecting the investors' rights built on this foundation. The beginning of corporate developments in India were marked by the managing agency system that contributed to the birth of dispersed equity ownership but also gave rise to the practice of management enjoying control rights disproportionately greater than their stock ownership. The turn towards socialism in the decades after independence marked by the 1951 Industries (Development and Regulation) Act as well as the 1956 Industrial Policy Resolution put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector. The situation grew from bad to worse in the following decades and corruption, nepotism and inefficiency became the hallmarks of the Indian corporate sector. Exorbitant tax rates encouraged creative accounting practices and complicated emolument structures to beat the system, in the absence of a developed stock market, the three all-India development finance institutions (DFIs)- the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India - together with the state financial corporations became the main providers of long-term credit to companies. Along with the government owned mutual fund, the Unit Trust of India, they also held large blocks of shares in the companies they lent to and invariably had representations in their boards, In this respect, the corporate governance system resembled the bank-based German mode! where these institutions could have played a big role in keeping their clients on the right track. Unfortunately, they were themselves evaluated on the quantity rather than quality of their lending and thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. Their nominee directors routinely served as rubber-stamps of the management of the day. With their support, promoters of businesses in India could actually enjoy managerial control with very little equity investment of their own.

Borrowers therefore routinely recouped their investment in a short period and then had little incentive to either repay the loans or run the business. Frequently they bled the company with impunity, siphoning off funds with the DFI nominee directors mute spectators in their boards. This sordid but increasingly familiar process usually continued till the company's net worth was completely eroded. This stage would come after the company has defaulted on its loan obligations for a while, but this would be the stage where India's bankruptcy reorganization system driven by the 1985 Sick Industrial Companies Act (SICA) would consider it "sick" and refer it to the Board for Industrial and Financial Reconstruction (BIFR). As soon as a company is registered with the B1FR it wins immediate protection from the creditors' claims for at least four years. Between 1987 and 1992 BIFR took well over two years on an average to reach a decision, after which period the delay has roughly doubled. Very few companies have emerged successfully from the BIFR and even for those that needed to be liquidated, the legal process takes over 10 years on average, by which time the assets of the company are practically worthless. Protection of creditors' rights has therefore existed only on paper in India. Given this situation, it is hardly surprising that banks, flush with depositors' funds routinely decide to lend only to blue chip companies and park their funds in government securities. Financial disclosure norms in India have traditionally been superior to most Asian countries though fell short of those in the USA and other advanced countries. Noncompliance with disclosure norms and even the failure of auditor's reports to conform to the law attract nominal fines with hardly any punitive action. The Institute of Chartered Accountants in India have not been known to take action against erring

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

auditors. While the Companies Act provides clear instructions for maintaining and updating share registers, in reality minority shareholders have often suffered from irregularities in share transfers and registrations -deliberate or unintentional. Sometimes non-voting preferential shares have been used by promoters lo channel funds and deprive minority shareholders of their dues. Minority shareholders have sometimes been defrauded by the management undertaking clandestine side deals with the acquirers in the relatively scarce event of corporate takeovers and mergers. Boards of directors have been largely ineffective in India in monitoring the actions of management. They are routinely packed with friends and allies of the promoters and managers, in flagrant violation of the spirit of corporate law. The nominee directors from the DFIs, who could and should have played a-particularly important role, have usually been incompetent or unwilling to step up to the act. Consequently, the boards of directors have largely functioned as rubber stamps of the management. For most of the post-Independence era the Indian equity markets were not liquid or sophisticated enough to exert effective control over the companies. Listing Requirements of exchanges enforced some transparency, but non-compliance was neither rare nor acted upon. All in all therefore, minority shareholders and creditors in India Remained effectively unprotected in spite of a plethora of laws in the books.

NEW OUT LOOKS ON GOVERNANCE AND CONTROL:

Management control is that critical aspect for maximizing company effectiveness, as it helps to obtain results in line with expectations through: centralized coordination, hierarchical development of targets and assigning targets to basic internal organization units, controlling consistency between targets and results, interpreting any differences between targets and results, and finally, preparing appropriate reports.

Corporate governance is thus a complex activity evolving in parallel with change within internal and external contexts. In particular, global competition shows how maintaining the conditions for company effectiveness implies: reviewing the corporate governance approach, emphasizing relations between governance and management control and developing appropriate skills to adapt to the variables being monitored(Figure 1).

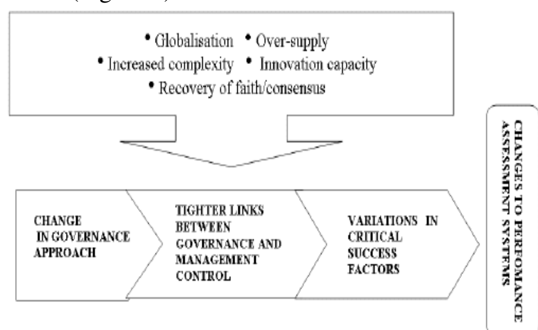

Figure -1. Impact of new outlooks on governance and Control

Indeed, management control must recast itself as corporate governance tries to fully acquire all those variables needed for company success. At the same time, governance must know how to exploit effective management control process opportunities that are part of the global internal control systems (internal control in a strict sense, internal auditing and management control) and that react in a tight relationship to cost/benefit logic.

NEED FOR CORPORATE GOVERNANCE IN BANKS:

Corporate governance in banks has assumed importance in India post-1991 reforms because competition compelled banks to improve their performance. Even the majority of banks and financial institutions, owned, managed and influenced by the government with neither high quality management nor any exemplary record of practicing corporate governance have realized the importance of adopting better practices to protect their depositors and the banking service.

Banks and development financial institutions in India, particularly DFIs, have an important role in the governance of companies where they have their nominee directors. The role of these nominee directors is to protect the interest of the institution and also as a member of the Board be responsible as any other director. However, in certain instances where irregularities have been detected, the role of nominee directors has attracted attention. However, it is felt in general that these nominee directors have a duty to act in the larger public interest. The focus on corporate governance is particularly acute in financial services and most of all, in the banking sector. The banking sector is already highly sensitized to public scrutiny and has learned to its cost the risk of attracting adverse publicity through failings in governance and stakeholder relationships. Banking is clearly a very special sub-set of corporate governance with much of its management obligations enshrined in law or regulatory codes. Governance is also a curiously two-sided issue for banks since their funding and, often, ownership of other companies makes them a significant stakeholder in their own right. Governance in banks is a considerably more complex issue than in other sectors. Banks will attempt to comply with the same codes of board governance as other companies. The other needs and importance of corporate governance in Indian banking sector are as follows :

- Since banks are important players in the Indian financial system, special focus on the Corporate Governance in the banking sector becomes critical.
- The Reserve Bank of India, as a regulator, has the responsibility on the nature of Corporate Governance in the banking sector.
- To the extent that banks have systemic implications, Corporate Governance in the banks is of critical importance.
- Given the dominance of public ownership in the banking system in India, corporate practices in the banking sector would also set the standards for

Corporate Governance in the private sector.

- With a view to reducing the possible fiscal burden of recapitalizing the PSBs, attention towards Corporate Governance in the banking sector assumes added importance.

KEY INDICATORS INFLUENCING CORPORATE GOVERNANCE IN INDIAN BANKS :

The structure and the corporate philosophy is highly influencing the intent and content of Corporate practices in the banking sector. The key indicators are Ownership structure, Structure of the company, financial structure and the Institutional environment. The indicators influencing of corporate governance are as given bellow:

❖ **The Ownership structure**: The structure of ownership of a company determines, to considerable extent, how a corporation is managed and controlled. Our corporate sector is characterized by the co-existence of state owned, private and multinational enterprises. The shares of these enterprises (except those belonging to the public sector) are held by institutional as well as small investors. Large shareholders tend to be active in Corporate Governance either through their representatives on company boards/through their active participation in annual general body meetings. This has been demonstrated by Reliance Industries Ltd., which has the highest number of equity shareholders spread across the country.

❖ **The Structure of Company Boards**: Along with the structure of ownership, the structure of company boards has considerable influence on the way. .the companies are managed and controlled. The Board of Directors is responsible for establishing corporate objectives, developing broad policies and selecting top-level executives to carry out those objectives and policies. The board also requires management's performance to ensure that the company is run well and shareholder's interests are protected. Company boards are permitted to vary in size; composition and structure to best serve the interests of the corporation and the shareholders. Boards can be single-tired/two-tiered with regard to the size of the board, opinions and practices vary. Some argue that the adequate size is to range from 9 to 15. Some put the figure at 10. Yet others recommend a minimum of 5 and a maximum of 10.

❖ **The Financial Structure**: Along with the notion that the structure of ownership matters in Corporate Governance is the notion that the financial structure of the company i.e., Proportion between debt and equity, has implications for the quality of governance. Recent research has shown contrary to the Modigliani-Miller hypothesis that the financial structure of the firm has no relationship to the value of a firm that the financial structure does matter; it is no secret that the lenders exercise significant influence on the way a company is managed and controlled. Banks can perform the important function of screening and monitoring companies as the (banks) are better informed than other investors. Further, banks can diminish short-term biases in managerial decision-making by favoring investments that would generate higher benefits in the long run. Banks play a more favorable role than other investors in reducing the costs of financial distress.

❖ **The institutional environment:** The legal, regulatory and political environment within which a company operates determines in large measure the quality of Corporate Governance. In fact. Corporate Governance mechanisms are economic and legal institutions and often the outcome of political decisions. For e.g. the extent to which shareholders can control the management depends on their voting rights as defined in Company Law and the extent to which the market for corporate control efficiency operates to discipline underperforming management will depend on take-over regulations.

ISSUES OF CORPORATE GOVERNANCE IN BANKING SECTORS:

The significance of Corporate Governance is to make sure the deliverables as promised to the stake holders of the business and commitment of the management of the organisation. It is evident through its transparency and value system they adopt over a period of time in maximising its value addition to the business. It ensures all the stakeholders in a bonding process, which is economic, and at the same time social .Corporate governance initiative for banks becomes imperative for the following issues:

- The linkages of the in financial institution and its stake holders for consistent source if founding and payment to all types of transactions.
- The transition of private sector banks into government through nationalization process has led to the consolidation of banking sector in India. But the finical inclusion of foreign banks and other private financial institutions. The Resurgence of banks in the capital markets and followed by the rapid changes in the ownership of banks necessitate changes in the reporting and governance standards poses a challenge in Corporate governance practices.
- The control of RBI over the functioning of the banks for its governance and control would continue the central monetary regulator in the economy though more independence and would be given in the Prime Lending Rate (PLR), operational areas and diversification opportunities available to the individual banks.
- In times of distress, banks are generally given access to the 'safety net' arrangements by the RBI or The Government of India. The concern for 'safety net' arrangement is expected to protect the payment system and the interest of the depositors. The systemic dimensions of these measures are also vital to the financial health of the economy.
- The influence of monetary sectors on Banks is highly leveraged entities and their success/failures would have impact on the monetary sectors of the economy.
- The expectations on the emerging corporate governance guidelines for banks would play vital role in fulfilling broader expectation of the society.

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

CHALLENGE OF CORPORATE GOVERNANCE IN INDIAN BANKS :

The challenges of corporate governance in Indian banks are as given bellow:

❖ Product innovation: Rapid changes in technology are leading to the introduction of hitherto unimaginable product and process innovation. Complex and versatile financial derivatives such as swaps. Options, caps collars etc. have thrown tough challenge to the bankers and supervisors. They often lack the technical expertise and have sophistication to properly comprehend the typical character of the instruments, let alone assessing the underlying risks.

❖ Market integration: Liberalization has necessitated of the instruments of barriers between money, capital and forex market paving the way for closer market integration. Fusion of different market segments to the other imposing additional strain on the regulations.

❖ Universal Banking: Combination of multifarious activity under the universal banking umbrella results in the creation of financial conglomerates. In India with opening up of the insurance sector many of the institution are offering both banking and insurance product since banking and insurance come under different regulatory jurisdictions, the authority to be ultimately responsible for ensuring stability and solvency of the institutions is a questions yet to be satisfied resolved.

❖ Giobalizations: With globalization no country can claim to be immune from cross boarder developments. For example the south East Asian currency crisis had its repercussions in the Indian forex market too. The aftermath of September 11, 2001 events in the US continues to haunt the global economic outlook including India. Another aspect of globalization is that a significant proportion of a global bank's business is catties on outside to broader of the home country. This makes them vulnerable to committee in that direction problems of standardization of the supervisory responsibilities and harmonization of the national accounting standards still persist.

❖ Technology: Of all the issue the industries face in the year ahead an stand far from the rest, how to deal with technology. Technology has become the key driver of banking business and it's redefined its boundaries. At the same time widespread use of computer and Internet technology has increased the risk of technology related frauds and malpractice. Current trend of transition from distributed to core banking will pose additional challenge.

EFFECTIVE CONDITIONS FOR CORPORATE GOVERNANCE IN BANKING SECTOR:

Many areas which require corporate governance practices in the banking sector can be found in Narasimhan Committee Reports (Committee on Financial System and Committee on Banking Sector Reform).

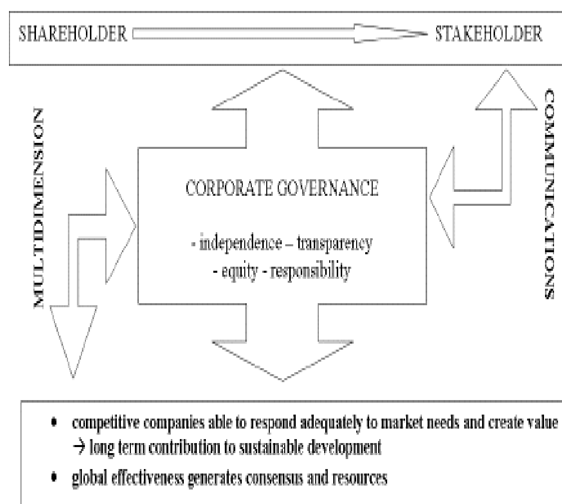

Figure -2. Effectiveness conditions for corporate governance

Following suggestions, therefore, may be kept in view for reforming the corporate governance system in the Indian banking sector:

1. The Board of Directors, two-thirds should be non-executive directors and majority of them should be independent of the institutions as well as Government.
2. Of the directors, two-thirds should be non-executive directors and majority of them should be independent of the institution as well as the government.
3. The non-executive directors should be appointed for an initial term of three years and reappointed for a maximum of three additional years.
4. The roles of Chairman and Chief Executive should be separated and the Chairman should ideally be a non-executive director. The appointment of Chief Executive and other whole-time directors should be made by the Board with the help of a Nomination Committee comprising of a majority of non-executive directors. The Nomination committee could have a nominee of the Government or any institutional shareholder having a stake of more than 26 per cent.
5. The Credit/Investment Committee of the Board should have a fair number of independent directors.
6. Audit committee comprising of independent non-executive directors should be made compulsory.
7. The Compensation committee of the Board consisting of non-executive directors and headed by a Chairman should be the final authority to decide the compensation payable to the staff.
8. The financial institutions should be brought under the regulatory and supervisory ambit of the Reserve Bank.
9. The management should be accountable only to general body of shareholders.
10. The regulatory practices should be aligned with international practices after making suitable modifications.

It is no exaggeration that good governance is absolutely essential for the financial institutions and financial intermediaries if these have to play their designated role in the domestic sector and to extend their reach to a global magnitude. Particularly when the financial institutions approach the capital market to procure funds, it is imperative for them to put proper governance in place so as to safeguard the investors' interest and to maintain their faith in the financial organizations

This paper suggests that bank regulation should seek to balance the interests of shareholders with creditors, depositors, and other stakeholder interests in order to achieve the overall objective of financial stability. Following are the major issues to be addressed for greater transparency and effective function of corporate governance in banking sector

- Independent Boards
- Board Sub committees
- Women on boards

CONCLUSION:

It would be too extreme to describe financial regulation as a substitute for corporate governance practices—it would be more accurate to describe its role as reducing the collective-action problem by ensuring that the broader standards and objectives of financial regulation are adhered to for the good of the broader economy and for most of the various stakeholder interests. The introduction of Basel II and international corporate governance standards for financial institutions necessitates that bank regulators from all relevant jurisdictions address these issues in a more systematic way than what has been the case in the past. Corporate governance is a rigorous activity evolving in analogous with change within internal and external contexts. In particular, global competition shows how maintaining the conditions for company effectiveness implies, reviewing the corporate governance approach, emphasizing relations between governance and management control and developing appropriate skills to adapt to the variables being monitored. The new attitude companies are up against tends to determine revising important critical factors for company success and changes resources important for the creation and maintenance of positive company/environment relations. More specifically, certain elements are taking shape that – though with different characteristics and importance based on specific company contexts and interaction with the environment. The special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels.

Corporate governance has assumed vital role and significance due to globalization and liberalization. With the opening of economy and to be in line with WTO requirements, if the Indian corporate have to survive and succeed amidst increasing competition globally, it can only be through transparency in operations. The excellence in terms of customer satisfaction, in terms of return, in terms of product and service, in terms of return, in terms of product and service, in terms of returns to promoters and in terms of social responsibilities towards society and people cannot be achieved without practicing good corporate governance.

REFERENCES:

1 Adams, R., and Mehran, H. (2002). Board structure and banking firm performance. Working Paper. Federal Reserve Bank of New York, http://papers.ssrn.com/paper.taf?abstractid=302593.

2 Arun, T. G., and Turner, J. D. (2004). Corporate governance of banks in developing economics: Concepts and issues. Corporate Governance: An International Review, 12(3), pp.371–377. Available at SSRN: http://ssrn.com/abstract=557319.

3 Arun, T.G and Turner, J. D. (2002a), "Corporate Governance of Banking Institutions in Developing Economies: The Indian Experience", Paper presented in the conference on 'Finance and Development' organized by IDPM, The University of Manchester.

4 Bae, K. H., J. K. Kang, and J, M. Kim. 2002. "Tunneling or Value Addition? Evidence from Mergers by Korean Business Groups." *Journal of Finance 57* (6): 2695-740.

5 Banaji, J and Mody, G (2001) "Corporate Governance and the Indian Private Sector", QEH Working paper Series Number 73, University of Oxford.

6 Banaji, J and Mody, G (2001) "Corporate Governance and the Indian Private Sector", QEH Working paper Series Number 73, University of Oxford.

7 Bertrand, M., P. Mehta, and S. Mullainathan. 2002. "Ferreting out Tunneling: An Application to Indian Business Groups" *Quarterly Journal of Economics* 117(1) 121-48

8 Bhattacharyya, A. K., and Rao, S. V. (2004). Economic impact of regulation on corporate governance: Evidence from India. Working Paper No. 486/2004. Indian Institute of Management Calcutta.

9 Chhibber, P.K., and S.K. Majumdar (1999), Foreign Ownership and Profitability Property Rights, Control, and the Performance of Firms in Indian Industry *Journal of Law and Economics,* 42, 209-238.

10 Claessens, S., 2003. Corporate Governance and Development, Global Corporate Governance Forum, World Bank, Washington D.C. > Claessens, S. and J.P.H. Fan, 2003. Corporate Governance in Asia: A Survey. Working Paper. and University of Amsterdam.

11 Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry M. P. Lang. 2002. Disentangling the incentive and Entrenchment Effects of Large Shareholdings, *Journal of Finance* 57 (6): 2741-71

12 Crespi, R., Garcia-Cestona, M. A., and Salas, V. (2003). Governance mechanisms in Spanish banks: Does ownership matter. Finance Working Paper No. 19/2003. European Corporate Governance Institute.

13 Das, A. and S. Ghosh, 2004. Corporate Governance in Banking System: An Empirical Investigation, Economic and Political Weekly, March 20, 2004, pp. 1263-1266.

14 Dyck, A. and L. Zingales (2002), Private Benefits of Control: An International Comparison, CEPR Discussion Paper No. 3177

15 Farar (1998), "Corporate Governance: A stakeholder Interpretation", Journal of Behavioral Economics, Vol.19, No. 4, pp.337-360

16 Gibson. M.S; Is Corporate Governance Ineffective in Emerging

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014

Markets *Journal of Financial and Quantitative Analysis*

17 Goswami, Omkar, 2002, "Corporate Governance in India." *Taking Action Against Corruption in Asia and the Pacific* (Manila: Asian Development Bank), Chapter 9

18 Gregory, Holly J., 2001, International Comparison of Corporate Governance: Guidelines and Codes of Best Practice in Developed Markets, Well, Gotshal_and Manges EEP.

19 Honohon, Patyrick and Daniela, Klingebiel (2000), "Controlling Fiscal Costs of Banking Crisis", World Bank Policy Research Paper No. 2441, World Bank.

20 Jensen, M.C., and W.H. Meckling (1976), Theory of the Finn: Managerial Behavior. Agency Costs and Ownership Structure, *Journal of Financial Economics,* 3, 305- 360.

21 Johnson, S., P. Boone, A. Breach, and E. Friedman 2000. Corporate Governance in the Asian Financial Crisis, *Journal of Financial Economics,* 141 -186.

22 La Porta, R., F. Lopez-de-Silanes, A. Shleifer, R. Vishny 2002. Investor Protection and Corporate Valuation, *Journal of Finance.* 57, I 147-1170.

23 La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny 1998. Law and Finance. *Journal of Political Economy,* 106, 1113-1155.

24 La Porta, R., F. Lopez-de-Silanes, A. Shleifer, R. Vishny 2000. Investor Protection and Corporate Governance, *Journal of Financial Economics,* 58, 3-27.

25 La Porta, R., Lopez de Silanes, F., and Shleifer, A. (2000). Government ownership of banks.Working Paper 7620. National Bureau of Economic Research, Massachusetts.

26 Levine, R. (2003). The corporate governance of banks: A concise discussion of concepts and evidence. Discussion Paper. Global Corporate Governance Forum, World Bank, Washington.

27 Levine, R. 2003. The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence, Global Corporate Governance Forum, World Bank

28 Macey, J.R.M. and O'Hara, M. (2003): The corporate governance of banks. *Economic Policy Review - Federal Reserve Bank of New York*, 9:91.

29 Reddy, Y.V., 2002. Public sector banks and the governance challenge - the Indian Experience, BIS Review 25/2002, bank for International Settlements, Basle.

www.IndianJournals.com
Members Copy, Not for Commercial Sale
Downloaded From IP - 210.212.129.125 on dated 6-Mar-2014