CAFRAL
CENTRE FOR ADVANCED FINANCIAL
RESEARCH AND LEARNING
Promoted by Reserve Bank of India

Program for Non-Executive Directors on the Boards of commercial banks and financial institutions was held on October 23-24, 2017, Mumbai

Takeaways from the Program for Non-Executive Directors on the Boards of commercial banks and financial institutions

The Centre for Advanced Financial Research and Learning had organised the two day program for Non-Executive Directors (NEDs) on the Boards of commercial banks and financial institutions from October 23 to 24, 2017 in Mumbai. The objective of the program was to sensitise the NEDs about recent regulatory developments, capital, risk, compliance, business strategy, governance issues, etc.

The summary/learning takeaways are as under:

1. Risk, Governance and Compliance – Role of Directors

Banks are distinct from other corporates as they are custodians of public funds; so the interest of depositors is relatively more than the interest of shareholders. Strong corporate governance, compliance and risk management are important aspects for banks and financial institutions. NEDs must be conscious of the areas where to take charge, where to partner and where to stay out of the way of the management.

Where board will Lead	Where board will partner	Where board will monitor	Where board will stay out of the way
• *Central idea/strategy* • *Selection of CEO (not applicable in case of PSBs)* • *Board competence, architecture, modus operandi* • *Ethics and Integrity* • *Compensation architecture* • *Accountability*	• *Strategy, capital allocation, execution* • *Financial goals, shareholder value, stakeholder balance* • *Risk appetite and culture of risk* • *Resource allocation, including mergers and acquisitions* • *Talent development* • *Culture of decisiveness*	• *Shareholder value* • *Compliance* • *Performance*	• *Execution* • *Operations* • *Delegated executive authority* • *Non-strategic decisions* • *Excluded by board charter*

The board must function cohesively and handle all disagreements tactfully. Both senior management and the board of directors must focus on two aspects: Capital planning and Liquidity. Raising capital is a costly proposition; but the board must recognize the need for capitalization at the right time, else it may be costlier. Liquidity is a critical element of a bank's resilience to stress. Boards must set a tolerance level for liquidity risk. In the post crisis era, Basel III has introduced two standards – Liquidity Coverage Ratio to strengthen short-term resilience and Net Stable Funding Ratio to strengthen resilience over a period of one year.

Other areas where boards must pay attention are strategy and risk management. There is no banking business without risk. A board must approve the risk appetite statement for the bank and ensure that the risk management practices go beyond just regulatory requirement or compliance. Boards must ensure that a proper risk culture is practiced in the banks/financial institutions. It is not adequate just to have a risk management framework. Risk management department may be asked to present the risk profile of the bank vis-s-vis the industry. Board must raise questions to ensure that sufficient and apt skill set is available in the bank so that the risk management framework is strengthened. The role of the Chief Risk Officer must be strengthened. The top management of any organisation is most concerned about their quarter to quarter performances and achieving their short term goals. NEDs must think beyond the short term performance to mid-term and long term achievements and frame policies suitably. Boards must maintain a balance by asking right questions to help the management see the blind spots in a proposal brought in by them without making the board dysfunctional. However, great policies are of no use unless implemented effectively. Good governance and risk management practices act as a deterrent to frauds, which have increased in recent years.

2. Financial markets and role of treasury

The treasury, as a function, is a very specialized one and people working there have to possess very good knowledge about the financial markets and market risk. Its role is to earn profit for the organization within the acceptable level of risk. It has several considerations across market risk, market conduct, returns, opportunities, culture and clients. It can be a very tricky area from a governance perspective. Multiple levels of checks and balances, including from independent third party experts, both from a governance and a business standpoint are needed. Boards must have policies in place for a strong governance and ensure that people do not misuse their position. All forex transactions must be fairly priced and customers must not be misguided.

3. Financial Statements and reporting

The Four basic financial statements for any business are:

- **Statement of Financial Position** which is nothing but the balance sheet, presents the financial position of a business at a given date;
- **Income Statement**, also known as the Profit and Loss Statement reports financial performance of a business in terms of net profit or loss over a specified period;
- **Cash Flow Statement** which presents movement of cash balances over a period;
- **Statement of Retained Earnings**, also known as Statement of Changes in the Equity, presents the details movement in owners' equity over a period.

Various ratios are derived from the financial statements, which ultimately lead to the financial assessment of the bank. The reporting integrity is very important and Directors have a major role in presenting a true and fair picture of the financial position through periodic reporting.

4. Regulatory perspectives on current issues

The stress in the banking system is continuously on the rise, particularly in the books of public sector banks and there is an urgent need to restore the health of these banks. Government of India has been infusing capital under Indradhanush plan which estimated that Rs.1.8 trillion needed to be injected in the PSBs over the 2015-2019 period. GOI had committed to inject Rs.700 billion in tranches over four fiscal years from FY15-16 to FY18-19. The expectation is that the remaining Rs.1.1 trillion would be raised by the PSBs from the markets. One way of raising capital is the Additional Tier 1 capital which has in-built loss absorbing characteristic. However, regulator is watchful about the timing of the issuance of these AT 1 bonds. Shifting of accounting standard to IND-AS 109 will have major implications for banks. Expected impact on regulatory capital is a cause of concern. Lending rate calculation is another area of study. Internal Study Group has reviewed the working of the MCLR system and the result is not encouraging. Thus, there is the recommendation of fixing lending rates linked to an external bench mark.

5. Fintech and Digital banking, Cyber attacks – recent developments

Internet has impacted the Indian economy in a big way. Digital data consumption rate in India is on the rise. Banking through digital channel has seen steady growth while branch banking is on a decline. Technology has brought in and continues to bring in series of changes in the way a bank functions today. Cost of serving their customers right to the lowest level of the society has come down remarkably. Fintechs play a major role in facilitating the disruptive innovative financial products or processes. Fintechs are here to stay and banks must embrace the wave of innovation and partner with the fintechs. India is one of the two countries which has online accessible biometric identity database for its citizens (Estonia is the other country). World’s largest biometric identity has been used extensively and is the key to the emergence of banking revolution. India stack proposes four technology layers

Presence-less layer *Where a universal biometric digital identity allows people to participate in any service from anywhere in the country*	**Paperless layer** *Where digital records move with an individual's digital identity eliminating the need for massive amount of paper collection and storage*.
Cashless layer *Where a single interface to all the country's bank accounts and wallets to democratize payments*	**Consent Layer** *Which allows data to move freely and securely to democratise the market for data*

A major risk area in Information Technology is the constant threat of cyber- attacks. Cyber- attacks have the potential to disrupt financial services that are crucial to both national and international financial systems and to endanger financial stability. The changing nature of cyber risk to financial institutions is driven by several factors, including evolving technology, interconnectedness among financial institutions and between financial institutions and external parties, and determined efforts by cyber criminals to find new methods to attack and compromise information technology systems. In the light of the increasing volume and sophistication of cyber threats, the Federal Financial Institutions Examination Council (FFIEC) developed the Cyber security Assessment Tool on behalf of its members to help institutions identify their risks and determine their cyber security preparedness. The Assessment tool provides a repeatable and measurable process for institutions to measure their cyber security preparedness over time. Authorities across the globe have taken regulatory and supervisory steps to facilitate both the mitigation of cyber risk by financial institutions, and their effective response to and recovery from cyber- attacks.

The role of the board, or an appropriate board committee, may include the responsibility to do the following:

- Engage management in establishing the institution's vision, risk appetite, and overall strategic direction.

- Approve plans to use the cyber security assessment tool.

- Review management's analysis of the assessment results, inclusive of any reviews or opinions on the results issued by independent risk management or internal audit functions regarding those results.

- Review management's determination of whether the institution's cyber-security preparedness is aligned with its risks.

- Review and approve plans to address any risk management or control weaknesses.

- Review the results of management's ongoing monitoring of the institution's exposure to and preparedness for cyber threats.

6. Stressed assets situation and resolution of stressed assets

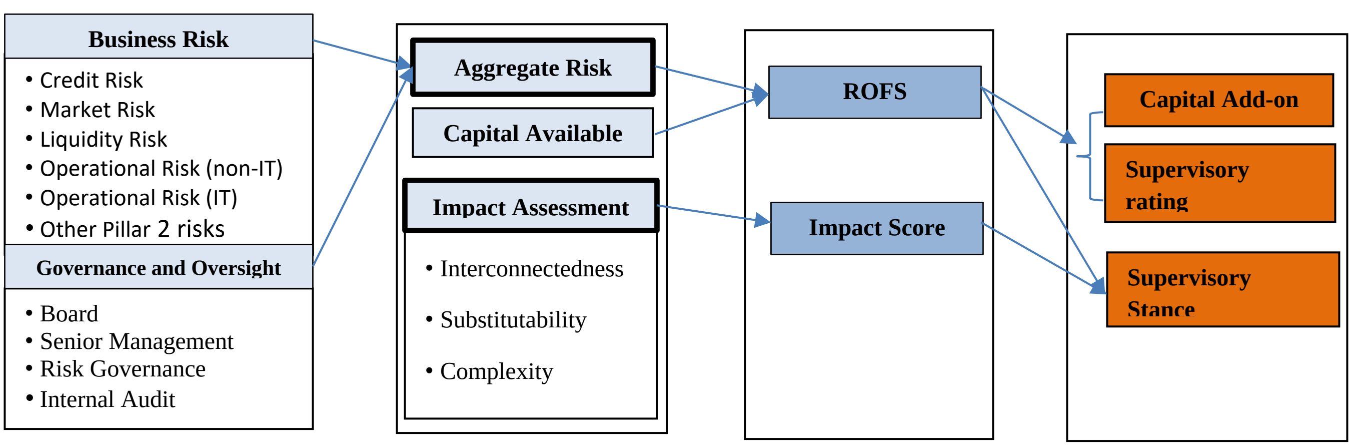
Stressed assets situation in India right now is of greatest concern. Recognised stressed loans are now at around 15% for the system and that of PSUs stand at around 19%. Reserve Bank of India has recently completed an Asset Quality Review and as an outcome the net slippage has risen to its highest level because of better identification of stress. Net Interest Margin has been declining and banks are reporting losses in recent quarters despite treasury gains. Factors behind build-up of stressed assets are:

- Global and domestic economic slowdown.
- Projects stalled at various stages due to delay in clearances and issues in fuel linkages.
- Persistent policy paralysis delaying structural reform.
- Significant build-up of excess capacity, financed mainly through excessive leveraging.
- Deficiencies in the credit appraisal and due diligence processes, particularly at PSU banks.
- Lack of capital cushion and effective resolution mechanisms.

Various regulatory responses viz. Corporate Debt Restructuring (CDR), Joint Lenders Forum (JLF), Strategic Debt Restructuring (SDR) and Scheme for Sustainable Structuring of Stressed Assets (S4A) did not help in reducing the NPA situation. Recently introduced Insolvency and Bankruptcy Code, 2016 is a law that seeks to protect value of businesses under stress and provides for a transparent and time bound resolution process. More than 220 cases and 900 Insolvency Professionals have been registered during the last nine months since its inception. Major issue in the resolution process is to have a fine balance between bankers and financial creditors, promoters, operational creditors including government and the consumers.

7. Risk Based Supervision

Reserve Bank of India has implemented Risk Based Supervision of banks in the year 2013 in a phased manner. RBI assigns scores to the banks based on their observation during their onsite supervision "Supervisory Program for Assessment of Risk and Capital" (SPARC), viz. Aggregate Risk Score (ARS), Risk of Failure Score (RoFS) and Impact of Failure Score. Based on the scores, the Supervisory Rating and Supervisory Stance are determined. Process flow from the data and information collected during onsite supervision under the SPARC framework is as under:



Compiled by CAFRAL Team.