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Role of Board of Directors in a Bank

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Corporate Governance

The Board of Directors in any company has people with different expertise, knowledge and priorities. While serving on the Board they need to act as a cohesive whole for the betterment of the institution they are serving, instead on focussing on the groups they represent.

Separation of ownership from management of corporates, and increasing shareholder activism make the Board increasingly responsible for acting as a bridge between shareholders and management, and for protecting the interest of the shareholders. For serving this purpose, the independent directors need to equip themselves by increasing their knowledge levels in general, and also specifically about the company whose Board they are serving on. They need to spend time in understanding the company-specific issues and the environment it operates in, by taking inputs both from internal company sources and from external independent sources. Induction programmes from the company can be a great contributor to this process. Presentations to the Board by departmental heads/senior managers help the former have a more detailed discussion on specific aspects of the organisation and thereby gain deeper knowledge.

There are certain factors that make corporate governance in banks even more important than in other companies. These are:

- Unlike other corporates where shareholders are the main stakeholders, a bank's main stakeholders are the depositors as a bank is a highly leveraged entity. The depositors' risk appetite is significantly less compared to that of its shareholders and management.
- A bank is a systemically important player, both as a participant in the payment and settlement systems, and as a counterparty to other banks and non-bank corporates. A crisis in a bank spreads much faster within the system than a crisis in any other corporate.
- Banks are the main conduit for the flow of credit in the financial system. The collapse of even a single bank can cause significant problems to its borrowers.
- A bank deals in large volumes of cash and non-cash substitutes and has a vast geographical presence; that makes it relatively difficult to control operations and exposes it to frauds.
- A bank has a vast variety of on-balance sheet and off-balance sheet exposures that can escalate very fast.
- A bank deals with complex financial products; the risks related to these products are difficult to identify and measure.
- Technology is being increasingly used in the field of banking. While this improves the operating efficiency of banks, it also exposes banks to a higher possibility of fraud and other risks like model risk.
- Value judgements and management estimates are much more frequent and subjective in banks.
- Process outsourcing is an increasing reality in the field of banking, which leaves it with much less control over the systems and processes.
- The failure of a bank can potentially need taxpayer funds to be used for bailing it out.

The responsibilities of the Board include:

- Discussing possible strategies, long-term objectives and the alternative ways of meeting those objectives with the management, and guiding the management in the final decision on these issues.
- Ensuring effective risk management. The three lines of defence for risk management are the staff, the risk owners (e.g. mid-office for trading, internal controls for frauds), and the audit function. The Board has to ensure that the risk management policy clearly defines and delineates their roles and responsibilities.
- Monitoring performance using pre-identified parameters.
- Ensure succession planning.
- Monitoring Corporate Social Responsibility.
- Ensuring regulatory compliance.
- Ensuring effective communication with shareholders.

An independent director's contribution to the proceedings of a Board meeting is taken much more seriously if the suggestions made by him are well-considered and well-informed. Directors can ensure this by preparing themselves in advance for the Board meeting. The preparations should include reading the agenda papers beforehand and deliberating on the topics that need to be discussed. For this purpose, the directors should insist that the agenda papers be delivered to them well in time. They should also be pro-active and ask for any additional information which they believe will aid the decision-making process. Mitigation of conflict of interest should be achieved by ensuring transparency in all processes in which independent directors are involved.

An important factor to be considered in the matter of effective discharge of an independent director's duty, is the segregation of the post of Chairman from that of the Managing Director. A non-executive director makes it easier for the independent directors to express their opinion about the conduct of affairs of the bank. A non-executive chairman can also resolve the disputes between the board and the management in an unbiased manner.

Macro-Economic and Monetary Developments

Banks are exposed to considerable risks compared to the regulated 80s when all banks had to worry about was credit growth. Deposit rates as well as lending rates were regulated, a large part of credit was directed, exchange rates fixed and the economy grew at a leisurely pace. Provisions for bad debts were an unknown phenomenon, hence banks could show growth aggressively without bothering about the soundness of the loans extended.

The macro-economic scenario today is completely reversed. Regulations these days focuses more on ensuring soundness of the banking sector, banks are exposed to all kinds of risks, economic growth is much more volatile, globally interconnected real and financial markets are a reality, volatile forex and debt markets are a part of daily life. Banks have to pay for their bad credit decisions by creating provisions for bad and doubtful debts, and hence need to take well thought out and informed decisions.

The global meltdown of 2008 brought banks' excessive risk taking and the resulting vulnerability under increased focus. The current economic scenario of reduced domestic and global demand, sustained domestic inflation, excessive fiscal and current account deficits makes for a very challenging environment for banks to do business in, especially when they face increased supervision.

An independent director's role becomes even more significant in tough times. Such times call for defensive rather than the aggressive strategies that managements of listed banks are likely to pursue in order to please analysts. Some examples of areas where an independent director needs to keep tabs are:

- In a rising interest rate scenario, banks may try to aggressively pass on the interest rise to borrowers, squeezing them further, and possibly weakening their ability to repay the loans. This might show better profits in the short-term, but would not be good for the medium-term health of the bank. Going for aggressive asset growth could end up with similar results. The independent director could bring the focus back to medium-term focussed strategies.
- A lot of banks follow a herd mentality when it comes to lending opportunities. Lending excessively to a particular sector could lead to trouble for a bank if structural bottlenecks or some other sector-specific problems result in financial problems for the sector as a whole. In this light, it would need to be evaluated whether a bank is heavily invested in a particular sector because every other bank is in the same position, or is it because they have identified an opportunity before others. Even if some investments fall under a herding asset class, they may still not lead to medium-term problems if based on exclusive knowledge gained by some geographical or relationship advantages enjoyed by the bank. It is very important for the independent directors to make this distinction.
- Interest rate risk is a very important constituent of market risk, especially so for banks. Excessive losses in the trading book have shaken-up many banks in the last few years. Independent directors should ensure that the Board pays adequate attention to the quality of investments, and creates adequate provision for possible losses. The availability of instruments like OISs and Interest Rate Futures gives a bank tools over and above duration management for active interest rate hedging.
- Funding risk is becoming a major cause for concern, both in terms of domestic funding and forex funding for banks having large foreign currency exposures. Boards of banks that have large forex exposures need to be extra vigilant about the developing circumstances in the countries of their exposure, and the changing liquidity and credit availability in these markets. As credit availability becomes tight, entities enjoying a lower credit rating are the first to face challenges in raising credit. As Indian banks' credit rating is limited by the country's (which can only be expected to worsen), they could face hurdles in financing their credit and liquidity requirements in these markets. Directors could help keep a lid on the situation by not letting the banks overextend themselves.
- Companies in certain sectors, especially in infrastructure, can sometimes face extraordinary levels of geopolitical risks, both domestically and internationally. The Board of any bank that has a large exposure to such companies needs to evaluate whether it understands the risks involved and is comfortable with them.

The increased volatility in the macro-economic scenario has been accompanied by a more responsive, market-linked monetary policy, made possible by the abolition of automatic monetization of government debt, enforced by the FRBM Act. Unlike earlier, when the policy's focus was on the asset side of banks' balance sheet (i.e. on the price, volume and distribution of credit), now the focus is on the liabilities side (i.e. on the availability of liquidity and the cost of raising resources). The three major areas that need special attention are liability management, treasury operations, and asset quality and adequate provisioning.

On the other hand, most banks continue to focus on asset growth and short-term performance. It is the independent directors' responsibility to understand monetary policy and its implications, so that they can bring the board's attention to the required strategic and tactical responses. Some inputs that can help directors in gaining this understanding and in predicting the direction in which monetary policy might be moving are:

- RBI forecasts
- Observing which channels (quantum, interest rate, exchange rate, asset prices) are being used by RBI to influence market conditions
- Hints given by RBI in the monetary policy as to its comfort levels, by way of difference in the language used at different times
- Signals given out by the Governor and the Deputy Governors in their speeches.

The role of independent directors is not static. Their focus needs to keep evolving according to the changing circumstances.

Strategic Planning and Independent Directors' role

The most important role of a Board is to provide guidance to the management regarding the long term strategy that it needs to follow. A bank needs to develop strategic competitive advantage, and the Board can contribute by ensuring that the management focuses on the long term rather than yearly performance. The two most important resources that need to be optimally utilized for this purpose are top management talent and capital.

Optimal utilization of top management talent requires the Board to get involved not only in the CEO succession planning, but also in asking questions about the recruitment and retention policy being followed for other personnel that are a part of top management. It is important to focus on brand building in this regard, as that would make it easier to recruit and retain the required talent.

Ensuring optimal utilization of capital entails much wider and deeper participation by the Directors. Approving the capital structure, dividend policy, accounts and major capital expenditure are a part of this process. Monitoring performance and providing guidance on the business strategy to be followed is also an important part of this process. For this, the Board would need to evaluate a number of parameters like:

- What are the emerging geographies that the bank needs to increase its presence in?

- What are the emerging sectors that would place huge demands on the bank's capital by way of requirement of loans? Is the management aware of the associated risks? Is the bank comfortable with these risks?
- How is the consumption pattern in the existing markets evolving? Who is the new consumer emerging in the market? What are the product needs of this new consumer and are his banking needs being met, or is there an untapped market that could provide huge growth prospects?
- How is the competition geared up for the emerging geographies and emerging consumer? Is the emergence of new consumer also allowing new competition to emerge?
- What is the new technology that is gaining popularity and how is it going to affect the banking business in the future? Is the bank geared up for the challenge or does it need to come up with new strategies for the same? Is there a requirement for a change in the business model regarding delivery of products?
- How is the regulatory environment expected to change in the near-term and long-term? Is it likely to become more or less restrictive? How is that going to affect the capital needs of the bank?

It is important to remember that while it is the Board's responsibility to evaluate the bank's strategy and to provide guidance where required, formulating the strategy, in itself, is the responsibility of the top management. The Board needs to make sure that the management is taking all the relevant inputs into consideration while formulating the strategy. It can do so by putting the right questions to the management, which would make the management focus on the relevant issues.

Risk Management

Risk touches every aspect of a bank's business. It is all pervasive and ever-present. Not only do the various assets and liabilities of a bank result in different kind of risks being faced by the bank, the same item may be exposed to multiple risks at any point of time. A particular risk can, at any time, lead to the bank facing a completely different kind of risk due to the changing circumstances.

The duty of a bank's board is not to manage the risk themselves, but to ensure that the required systems are in place that ensure that all the risks are understood (which involves identifying, measuring and monitoring of risks), managed and priced appropriately by the management. Management of risk involves putting risk mitigation rules are in place, and confirming that there are triggers that ensure adherence to these rules.

Risks faced by a bank can be classified into five major categories:

- Business Model Risk: This is the risk arising out of the specific business model being followed by the bank. In case of a change in the business model, the directors need to evaluate the change path to ensure it is viable.

- Credit Risk: Includes not only the risk of default, but also of migration, as that can result in higher capital requirement.
- Liquidity Risk: This risk can be of two kinds. One is the risk of the securities/ instruments being held by the bank turning illiquid, and the other is the funding risk, i.e. the risk of the bank being unable to meet its obligations. These obligations could either be regarding a liability, or regarding a commitment to fund a particular project.
- Market Risk: This risk can arise at extremely high speeds and the impact could be significant enough to wipe out the entire net worth of a bank. Hence, market risk mitigation systems need to be very strong and responsive to emerging circumstances.
- Operational Risk: Banks' operations are expanding in volumes and across geographies at a fast pace, leading to increasing use of technology across various activities. This has resulted in enormous operational risks being faced by banks. Inadequate systems to manage these risks could even result in systemic damage.

There are certain guidelines that a bank's board can follow in order to ensure that the risk management process is adequate:

- The Board should confirm that any risk is taken on by choice and not by chance. This involves the existence of systems that result in only agreeable risks being taken on after being thoroughly understood. If unknown risks are being faced by the bank, it shows that the system needs fine-tuning.
- The approach to risk management has to be integrated across assets and liabilities and also across various kinds of risk. A segmented approach, or an approach where only one department is held responsible for risk management, would not lead to desired results. Risk management has to be the responsibility of the whole organisation.
- Risk management should not result in compromising with either profitability or the long-term sustainability of the bank. Risk management cannot mean avoidance of all risks, it should result in the risks being understood, and only those risks being taken on that can either be borne as they are, or can be mitigated to an extent where they become acceptable.
- A very important factor in risk mitigation is the availability of personnel capable of implementing the policy. Skills and capability of people responsible for managing risk, is as important as the policy itself.
- Even in areas where independent directors do not have in-depth knowledge, asking simple questions based on common sense can sometimes lead to the discovery of loopholes in the systems that need to be fixed.
- The risk template is one of the important documents that come to the Board. It indicates the level and trends of the various risks faced by a bank. The Board could insist on it including future projections, in order to identify potential problem areas.
- Concentration risk and off-balance sheet risks deserve special attention from the Board, as these risks could be underplayed by models used to measure various risks.
- Mathematical models that are used to measure risks have their own limitations and drawbacks. Beyond a point, intuition and discussion should play an important role.

- Global regulatory changes can sometimes have a huge direct or indirect impact on a bank's business; hence need to be carefully followed.
- Interconnectedness of various risks should be taken into account at all points of time.

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