Governance Practices – Looking Beyond Regulations[1]

Let me begin by explaining an apparent question embedded on the topic title of today's keynote remarks. First, regulator's talking about governance 'practices' rather than governance 'regulations' and second, taking the subject 'beyond' the realm of regulation. The answer lies in the truism that governance does not offer itself as a perfect candidate for laws and regulation or for that matter audit. A regulator cannot and should not become an alter ego for bank management. As RBI seeks to make regulations more principle-based, moving away from prescriptive regimes, presuming progressive maturity of Indian banking, it often confronts a Catch 22 situation. Absence of specificity in regulation is often held as grounds for sidestepping obvious regulatory intent at times even by mature entities. This would typically end up as imposition of incremental regulation on each micro aspect which is violated by a miniscule, adding avoidable regulatory burden on a bigger number of institutions who did not deserve it. In such circumstances, a possible middle path is to adopt a principle-backed base line regulatory regime with broad guard rails to majority of the banks and leaving it to their governance machinery to acquiesce in spirit. The deviant and inappropriate conduct is evaluated under supervisory processes for case specific intervention. This could sound more palatable if we try to relate it to the experience of collective or group punishment received in school days, all because of one naughty classmate nobody wants to name. Governance, one would say, could degenerate to such a subject, if those in charge of governance do not demonstrate responsible behavior in practice.

2. History of banking precedes history of banking regulation or for that matter setting up of the Basel Committee which guides a good amount of banking regulation. The current capital-centric regulation prescribes T1, T2 (Tier 1 and Tier 2) capital to address all and sundry risks. But let's not forget that before T1 or T2 capital nomenclature was invented, the banks were running on T0 which formed and still forms the foundation of all other forms of capital. This is called Trust Capital and trust can be won only through good governance and ethical practices. Hence, governance is a matter the regulator cannot be oblivious to despite the formlessness of the subject. While legal and regulatory architecture provide a broad

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framework to maintain the trust, the trust needs to be rooted in good governance and ethical conduct of the banks and its functionaries. Possibly, one way of driving home the relevance of the topic today can be better appreciated from a cliched imagery of regulations leading horse to water and watching over whatever follows.

3. Since some of the directors on the board of banks come with valuable experience in diverse non-banking or non-financial fields and there is a trend of directors with cross- sectoral expertise being inducted into bank's board, it will not be out of place to re- emphasize that the corporate governance in banks is very special and different from what would be applicable elsewhere. The first comprehensive guidelines on corporate governance in banks issued by RBI in 2002 succinctly stated the reasons as follows:

Banks are "special" as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but also they leverage such funds through credit creation. They are also important for smooth functioning of the payment system. In view of the above, legal prescriptions for ownership and governance of banks laid down in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time.

The distinction can further be understood in appreciating shareholders' theory vs. stakeholders' theory. In case of the former, while non shareholders are viewed as 'means' to the 'ends' of profitability, in case of the latter, the interest of many non-shareholders are also viewed as 'ends'. By corollary, consequences of corporate governance of a non-bank company may be restricted to its shareholders / creditors whereas failure of corporate governance in a bank can have serious consequences on the financial system at large and the impact can swiftly spread through its interconnectedness to other financial institutions and real economy entities.

4. Any discourse on bank governance would logically have to start with the promoters or owners that is often a critical driving force for the path the bank governance adopts. In the context of classic principal-agent approach to governance, banks with effective concentrated ownership and banks over-diversified both suffer from a different set of governance risks arising from the misalignment of incentives between

shareholder and management. While this is still an important factor to reckon with, let us limit our discussion to the areas of internal governance of banks, starting from the Board, where regulation tries to provide some beacons. Reserve Bank had issued a discussion paper on "Governance in Commercial Banks in India" in June 2020. The intention of this discussion paper was to enhance governance standards in banks and align the current regulatory framework to global best principles with domestic contextualization. The vital operative parts of the standards, based on large scale feedback received to the discussion paper, were issued by way of a circular in June 2021 as the comprehensive directions are due for issue now.

With the above as backdrop, let me try to present a few select aspects of regulations around bank governance where the responsibility of detailing may lie with you and potentially be a subject matter for supervisory evaluation.

(a) Responsibilities of Board of Directors

Suffice it to say that the overall and ultimate responsibility for the bank's performance, conduct and control rests with the board of directors. Each director, regardless of the manner of appointment or field of expertise, is responsible for the bank's overall interests. The board needs to be actively engaged in affairs of the bank, including keeping abreast of material changes in the bank's business and external environment as well as acting in a timely manner to protect the long-term interests of the bank. The toolkits available in achieving these regulatory responsibilities include setting up appropriate governance structures and practices, forming key policies, developing strategic plans and selection of best-fit CEO and Whole Time Directors (WTDs) supplemented by a robust and sensitive assurance function. While the terms may sound well-worn, but they differentiate a good bank from a not-so-good bank. Let's appreciate that a policy is just as good as its implementation and cultural assimilation rather than its documentary quality. Identifying and managing conflict of interest or adversarial related party transactions sounds easier than practicing. The nub lies not in handling only those transactions that fit the bills of laws or regulations as such but those which may be technically compliant with them but not conforming to best governance practices.

Speaking of culture, one must be very ethical as to how the conduct of the bank towards customers is understood from top downwards. They are not just grist to mill. When the vertical voice of customers becomes horizontal voice, the bank is bound to lose trust of not only the customers but also potentially that of the regulators.

The responsibility for ensuring accountability of senior management, including for misconduct, shall lie with the board in the absence of any individual accountability regime in India unlike many other jurisdictions. If any concerns relating to the senior management arise in the view of the board, which may have a major bearing on regulatory or 'fit and proper' status, there should be expeditiously communicated to the Reserve Bank. The Four soft pillars of board effectiveness, lies in (i) the people in the board, their competence and engagement; (ii) the information architecture; (iii) the structure and processes and finally, (iv) the group dynamics and each board member can prepare their questionnaire in self-evaluation.

(b) Assurance Function:

Owners, investors, government, regulators, management, and other stakeholders of a bank need to rely on the successful conduct of business activities, sound internal processes and the production of credible information. This is universally achieved through assurance function and an assurance map can be a powerful vehicle providing insights for boards, senior management and audit committees. Across industries and time, "three lines of defense" of The Institute of Internal Auditors (IIA) has been an accepted standard of operationalizing risk management programs since 2013. This was updated in July 2020 by a more principle-based approach named as "*Three Lines Model" which can form the cornerstone for assurance functions of banks. The lines are "not intended to denote structural elements but a useful differentiation in roles*". Understanding of the refreshed model can sharpen the board's ability to successfully manage risk by contextualizing to organisational value and resilience to it. For the sake of better visualization in banking context, the first line is formed by business function, second line by risk management and compliance function and third line being the internal audit function. In my view, assurance is a subject matter which requires comprehensive and dedicated sessions of understanding rather than being an appendix to broad Governance matters.

(c) Board Policies, Practices and Processes

Robust policies of a bank are not ornaments of governance but are increasingly becoming tools of delegated regulation rather than de-regulation. In large or growing institutions, this not only acts as a backstop for deviation from the desired course across both in short and long term, but it also actually helps the assurance function stay the course, when supplemented with lucid documents on procedures and processes. Identification of ‘critical processes and policies for its operational resilience is another important factor that should be taken cognizance of. In particular, the processes around strategy, evaluation, CEO succession, risks, board education, assurance function, regulatory compliance, onboarding / outboarding assume vital significance to improve the value of marginal contribution by directors more enriching to governance framework.

It will be apt to make a mention of throughput rate of board agenda that is often an elephant in the room, almost literally, which few really see. While it was earlier ascribed to calendar of reviews prescribed by the regulators, there was not much change even after RBI moved from prescriptive reviews to thematic review expectations. This does results in ‘gloss-overs’ of information that comes before the board and the board must rediscover its focus through agenda reengineering. While presence of ‘busy’ directors may be one factor for such gloss-overs, prescribing a more efficient board information architecture, custom-built metrics, and sufficient pre-meeting devotion could provide some of the answers. Another common feature that makes its way into the board deliberation without notice is Anchoring Bias which in plain terms translate to discussion around the information or projections made in the agenda without independent view on the relevance or completeness of inputs. An eye on omissions would improve the quality of board inputs in long term and improve the throughput rate.

(d) Senior Management

To enable the board to carry out its responsibilities, facilitate effective decision-making and ensure good governance, the board needs to establish and be satisfied with the bank's organisational structure. a clear demarcation of duties/ responsibilities/ authorities between the board and management as also between each of the management functions needs to be ensured. The three golden words for eliciting the best outcome from senior management are clarity in their (i) goal (ii) role and (iii) Board expectations. The NEDs should provide constructive and credible challenge to the senior management through the Board and hold them to account effectively with *ex ante* listing of possible consequences (including termination) if actions of senior management are not aligned with the board's performance expectations and standards.

5. Having enumerated the four important building blocks of governance in banks, it will be worthwhile to deliberate on certain empirical aspects as well.

(a) Independence of Independent Directors

De facto independence of de jure independent directors are currently under the spot light by many regulators world over. Independence is a quality that can be possessed by accomplished individuals and is an essential characteristic of professionalism and professional behavior. Financial sector regulations have been increasingly shifting reliance to independent directors considered expert in certain fields for sound governance. While independence of mind is the actual critical attribute necessary for directors to do their jobs, regulators are made to use various surrogates as measure of independence for lack of better alternatives. However, due to prescriptive definitions, there are categories of people who can be easily identified as non-independent but get aboard due to operations of a legalistic view. While the rules cluster around financial independence, it has very little to offer in terms of emotional independence of such persons on directorship. Of late, trend has also been observed of common personages acting as independent directors both in banks and its subsidiaries / associates or parent company. Cases of powerful MDs or promoters and pliant independent directors / chairman is a symbiosis for invisible break-down of corporate governance. Directors with independent views often find few friends on a board during meeting time and thus, the source of a counterview slowly fades, and the unintended groupthink and conjoined views, flourish. Nonetheless, it is important to distinguish between what is critical and what is not while expressing counterviews and one must be clear if it is based on knowledge or just judgement.

(b) Business Model & Strategy

'Know your bank' is the first requisite of being an effective director, independent or otherwise. There are many approaches to understand this. The core strength of a bank when harnessed may produce better results. While transformation is an essential component of growth, the board should be aware when the model or strategy changes with a new incumbent as CEO to understand the changed risk return profile and corresponding strategy. This will place the directors of the board in better position of oversight than a managed sub-conscious drifting.

(c) Succession Planning

Succession Planning for banks is a simple but targeted framework to identify new leaders both internally and externally and effectively manage critical transitions. Proactive succession planning and management is a key governance tool in promoting a bank's managerial and operational resilience. Succession planning straddles across short term succession, long term succession, management succession as well as board succession. When management succession plans are neglected, banks are often unprepared for the loss of key management heads. While personnel turnover is inevitable, recent trends of unexpected occurrences arising from setting up of new banks / growth strategy of existing banks, cross-industry movements, need for specialist in both business and assurance functions etc. instill turmoil in management teams, particularly when the succession program is dormant. In cases of certain banks with aspirations, the turnover / attrition level at lower positions could almost give it a look of dependence gig workers. Banks running with interim CEOs / KMPs or with vacant board seats do not present a wholesome sight and has been warranting serious supervisory attention. Banks continuing with *ad hoc* chairmanship of personages not found fit for regular Chairmanship is another dilatory practice which does not represent best practices in corporate governance.

(d) Compensation

Despite lots of principles set out for minimizing perverse incentives through compensation to top executives and material risk takers, boards and NRCs should be recommending packages for top executives in private banks that is well connected with risk-adjusted assessment of performance and external / internal equity in compensation.

(e) Business Conduct

The world over, including in Reserve Bank, the business conduct by banks has a place of distinct importance and it is closely linked to the ethos, ethics and trust that we discussed in the beginning. The areas which are getting current regulatory attention in RBI include lack of responsible lending conduct by way of unreasonable rate of interest or penal interest, a rentier approach to fees, forced bundling of cross-sold products, non-transparent zero-cost facilities, lack of efforts to return unclaimed deposits to its rightful beneficiary etc. The tactical role of target setting in creating moral hazard issues has historical evidence in case of some of the largest banks globally.

(f) FinTech Collaboration:

While this is a much talked about subject in recent times, there is no gainsaying that FinTech innovations have helped all financial service providers, including banks, to grow and adopt newer business models and strategy. It is not that this is an entirely new phenomenon but the degree, nature and mix of dependence on such collaboration is undergoing tectonic shifts. This has created an ecosystem that has prompted experts to brand this as banks' shifting from a 'manufacturing' model to 'distribution' model with quietly underpinned revenue and risk sharing contracts. Disruptive regulations are not seen through a similar glass as disruptive innovation is seen. While banking is one of the most regulated spaces anywhere in the world, innovation by definition happens in a different environment and such developments do not necessarily count regulatory compliance as one of the features of innovated products or services *ex ante*. As regulators trail to have a complete understanding of this and make proportionate regulation, if warranted, the business is bound to run relatively higher regulatory risk. This, in the process, might also add to the uncontrollable costs and un-modifiable risks which need to be fully appreciated while trying to reap the first mover advantages. Business partnership with unregulated entity or agency business of any unrecognised products / services will always carry some risks. With Digital Personal Data Protection Bill under consultation process, the final shape of the data protection law may infuse newer sets of challenges in such collaboration or partnership that the directors should be alive to.

6. The appropriateness of the theme of today's program on governance and assurance could not have been better evaluated than econometrically. For those who even slightly subscribe to the thought of governance being a necessary aside to business imperatives, an RBI Research paper, titled "Governance, Efficiency and Soundness of Indian Banks" published in August 2022 had the following conclusions to make.

(a) Although banks in India have made significant progress in adhering to governance standards over the recent years, the current level of compliance is not adequate to mark the existing governance structure as "socially efficient".

(b) The degree of governance compliance in banks significantly explains their soundness level. Non-adherence to governance principles can undermine the soundness of the banking system. An emphasis only on stringent compliance with board attributes without due attention to other important aspects of governance, including risk management and audit functions, can have implications for bank soundness.

(c) Profit-efficient banks are sufficiently sound to keep up capital buffers and absorb shocks, which may diminish destabilising effects. Therefore, to avoid the risk of bank failure in the long run, business practices that assure sustainable profits with proportionate risk need to be encouraged.

(d) There exist noticeable asymmetries in the policy priorities of banks on the dimensions of governance and soundness. Private banks demonstrated relatively better performance in adhering to governance norms pertaining to audit function, followed by risk management and board effectiveness during the study period (2009-2018)

7. In conclusion, I would say that a bank's failure to follow good practices in corporate governance and the lack of effective governance are among the most important internal factors which may endanger the solvency of a bank. This is not a theoretical postulate but we have had very clear evidences of that in India in the recent past. At the same time, there is no one model of corporate governance adaptable to all banks, though the principles and priorities remain the same. In the banking sector, corporate governance is therefore a way of business. A cycle of mistrust in banks is the worst thing that can happen to financial stability goals of the Reserve Bank as well as the country.

I am tempted to refer to The Edelman Trust Barometer 2022 which puts the trust of Indian public in Reserve Bank at 84 per cent – fourth highest among 28 countries rated. If that is used as a proxy for trust in banking in India, it is too valuable a heirloom for Indian banks to be frittered away for narrow or short term interest. Ernest Hemmingways's take on bankruptcy will always be instructive when he famously described how one goes bankrupt. "Two ways, Gradually and the Suddenly". The first way of gradual bankruptcy, not necessarily in accounting terms, is something an active board can prevent.

I conclude with my best wishes for the program and with hopes that the participants go back to their board rooms with better understanding of not only different building blocks of governance particularly in regulatory perspectives but the overall visualization of governance as an overarching concept.

Thank you.

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