Corporate Governance

*Deepak Pande

Background:

Internationally, there has been a great deal of debate going on for quite some time. The famous Cadbury Committee defined "Corporate Governance" in its Report (Financial Aspects of Corporate Governance, published in 1992) as "the system by which companies are directed and controlled".

The Organisation for Economic Cooperation and Development (OECD), which, in 1999, published its Principles of Corporate Governance gives a very comprehensive definition of corporate governance, as under:

"a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders, and should facilitate effective monitoring, thereby encouraging firms to use recourses more efficiently."

Generally, Corporate Governance refers to practices by which organisations are controlled, directed and governed. The fundamental concern of Corporate Governance is to ensure the conditions whereby organisation's Directors and Managers act in the interest of the organisation and its stakeholders and to ensure the means by which managers are held accountable to capital providers for the use of assets. To achieve the objectives of ensuring fair corporate governance, the Government of India has put in place a statutory framework.

Boards could broadly focus on four key areas of creating vision, mission and values; formulating strategy and structure; adequate delegation to top management; and exercising accountability to shareholders and being responsible to relevant stakeholders. Ideally, Board acts as a bridge between top management and stakeholders (including shareholders). It is expected that Board would protect the interests of the minority shareholders who are not represented on the Board.

Evolution of Corporate Governance:

Out of the several initiatives on Corporate Governance, the first one was initiated by Confederation of Indian Industry (CII) in 1998. In early 2000, SEBI accepted recommendations of Kumar Mangalam Birla Committee, those are defined under clause 49 of the listing agreement of the Stock Exchanges. Naresh Chandra Committee appointed by Department of Corporate Affairs submitted its report in December 2002, covering financial and non-financial disclosures. SEBI set up another committee, under the chairmanship of Narayan Murthy, which submitted recommendations on audit committee, audit reports, independent directors, connected part transactions, risk management, director appointment and compensation, code of conduct and financial disclosures. Ministry of Corporate Affairs published voluntary guidelines on Corporate Governance in 2009, which were divided into Board of Directors; Responsibility of Board; Audit Committee; Auditors; Secretarial Audit; and Whistle Blowing Mechanism. Keeping in mind, recommendations of R H Patil Group, Dr A S Ganguly Consultative Group and M S Verma Advisory Group, RBI issued several measures to strengthen the Corporate Governance of Indian Banking Sector.

The key players in the Corporate Governance comprise of Board of Directors, Management, Shareholders, Customers /Consumers, Employees, Regulators and Suppliers/Vendors. Corporate Governance principles define role and responsibility of board; protection of minority shareholders; Interest of other stakeholders; Integrity & Ethical behaviour: and Transparency & Disclosures. The objective is to enhance performance of the companies, Access capital from markets, Building sustainable advantage, Prevention of dishonest practices and Corporate Social Responsibility. Corporate Governance spells out voting

rights of the shareholders, Capital Structure, purposes for holding shareholder meetings, Board structure & its responsibilities, frequency of board meetings, nomination & selection of directors, Formation of board committees, Financial & non-financial disclosures, Audit Committee responsibilities, Conflict of interest disclosures, Internal control & risk management system and Promoters ownership & control.

Importance of Corporate Governance

Measure of Organisational Efficiency:

It determines the competitiveness amongst peers in the Industry besides aiding in answering how the company is governed these days. Efficient governance enhances performance of the Corporate as well as deliver good economic outcome. Corporate Governance lays down solid foundation towards culture of the company, resource utilisation, sustenance coupled with innovation of products & services and overall strategy at corporate level.

Optimisation of Shareholder Value:

Although there is no established relationship between corporate governance and market capitalisation of the company yet sound practices does enhance shareholders satisfaction. Good governance plays a vital role in enhancing market value of the company that, in turn, maximize the shareholders value. The reputation build over a period of time could be wiped out by way of a stray unethical event, thus internal controls should be in place mandatorily.

Compliance and Risk Mitigation:

Formation of risk committee is part of good corporate governance. Risk Committee ensures control over operations and other aspects where control is required. Risk mitigation, good governance and compliance go hand-in-hand. Good governance lays down solid foundation, resulting in efficiency and compliance of laid down systems and procedures besides statutory compliance. Immaculately following legal and procedural guidelines ensures that company is well prepared for any uncertainty, which does mean risk mitigation mechanism is in place. A disciplined company would always be well placed to counter risk or disruption arising out of unforeseen circumstances.

Better Reputation during Economic Slowdown:

In the backdrop of increasing frauds, financial malpractices and questionable related party transactions, the credibility of the corporate is likely to get compromised that is not always true. By formulating a vision, mission statement and values for the employees to adhere to during the course of doing business, a company could build the trust of the stakeholders. Brand reputation that gets build over a period of time plays key role in upholding company's reputation in uncertain times.

Crucial Role during Merger & Acquisitions:

During restructuring exercises involving Mergers and Acquisitions, good governance plays a critical role. Whenever a Merger & Acquisition deal is announced, good corporate governance helps an investor or prospect to differentiate between good deals with bad ones. A well governed company announcing a M&A deal is well received by the stakeholders in the market. Merger & Acquisitions could also be viewed with another dimension where one could see scope of improvement in the quality of corporate governance.

Corporate Governance in Banks:

Corporate Governance has to be effective for proper functioning of Banks and economy as a whole. Maintaining higher standards of Corporate Governance augments the confidence of the investor/stakeholders in the Banks. While there are multiple approaches to good Corporate Governance, Basel Committee principles, first issued in 2010 followed by revised set of principles in 2015, provide an outline that help Banks to formulate robust and transparent risk management policies and decision making by top Officials of the Banks. Adopting guidelines would help build trust of the public, in general, and enhance safety and strength of the Banking system. It helps create value for shareholders. There should be accountability even at the senior levels when lapses get noticed. Of late, several issues came to limelight on corporate governance, which need to be mitigated if could not be eliminated altogether.

Basel Committee Principles:

- Enhancing role of Board of Directors to govern the implementation of effective risk management policies.
- Emphasizing importance of joint & several responsibilities of the Directors to devote adequate time for their mandate and keep themselves aware of dynamic banking scenario.
- Formulating guidelines for top management in evaluating processes used by the Banks to identify & select Board members and Senior Officials.
- Strengthening guidance of the risk governance, including the risk management roles by strategic business units, risk management teams, and internal audit & compliance functions, underlining the significance of sound risk culture to drive risk management within the Bank.
- Bank's compensation systems convey acceptable level of risk-taking behavior and reinforce the Bank's operating and risk culture for Board members and top management.

Meanwhile, Committee, chaired by, Dr. P. J. Nayak, to review Governance of the Boards of Banks in India submitted its recommendations in May 2014. Some of the recommendations of the Committee on Corporate Governance are reproduced. It commented upon the fragile financial position of the Public Sector Banks, partly masked by the regulatory forbearance.

Board Members of the PSBs are unclear about their focus on business strategy and risk management. The paradigm shift in remedying onerous situation lies primarily with the Central Government. The report proposes Central Government to distance itself from several governance functions those are currently discharged by it. Recommend formation of Banking Board Bureau for initiating Board level appointments in PSBs.

Major Recommendations for Public Sector and Private Sector (old & new generation) Banks:

- Considering lower productivity, delinquent asset quality and market un-competitiveness, these Banks either be privatized or design a robust governance structure that would ensure market competitiveness besides avoiding repetitive dependence for capital infusion.
- These Banks have dual control by regulator as well as Finance Ministry; appointment of CMD & ED for short tenures as compared to private sector counterparts; compensation structure; external vigilance; and applicability of RTI Act. The aforementioned constraints drastically curtail ability to compete with the peers in the private sector.
- The Government should consider reducing its stake below 50%, in order to have a level playing field with private sector peers.
- The transfer of Government holding in Public Sector Banks to Bank Investment Company (BIC), and transferring of powers to PSB Boards with an intent to fully empower them, could be implemented in 3 phases.
- It would be desirable to provide minimum of 5 years period to CMD and 3 years to ED.
- Wherever significant ever greening in a Bank is noticed then un-vested stock options to the concerned officials may be cancelled in part or full; monetary bonus paid be reversed in part or full; and audit committee head to step down from the Board.
- Board of all Banks, and particularly of new generation private sector Banks needs to formulate product suitability matrix on customer protection in distribution of third party products.
- Profit linked incentives for non-executive directors should be allowed post completion of all three phases of transition.
- For old generation Private Sector Banks where RBI has doubts about independence of controlling shareholders of the Banks, all Director appointment be made with the prior approval of RBI.
- In an entrepreneur-led Bank where promoter is also the CEO, RBI should satisfy itself about board's independence and adequate diversity with professionals from varied fields. Wherever RBI is not satisfied with the composition of the Board, and lacks confidence in the independence, the promoter CEO should be asked to step down.

Questionable Governance:

- A company based abroad earning commission, whose founder falling under related party definition applicable to the CEO of the Bank, getting mandate to restructure foreign currency loans, as part of quid pro quo.
- Recent spat between a private sector Bank and the Regulator over the dilution of the ownership control where matter is Sub judice now.
- A Bank extending loan to a company with potential conflict of interest raises doubt over the lender's governance and creates reputational risk.
- Under AQR, Regulator found huge divergence in the Non Performing Assets reported by the Bank than what was identified by the Regulator.
- Lack of requisite expertise among top management officials. Officials without adequate experience and expertise appointed/promoted to head respective segments.
- Board of a Bank giving clean chit to a CEO without carrying out investigations. The Board had to ask the CEO to quit post getting investigation report.
- Poor compliance structure and serious violations of statutory and regulatory guidelines without any accountability on Bank Officials.
- The entire blame of procedural lapses attributed to junior staff, thereby protecting seniors who failed to anticipate and issue/reiterate operational guidelines in time.
- In order to drive business, the quality of credit proposals compromised when reporting line resulted in conflict of interest, thereby violating spirit of RBI guidelines.
- Promoting officials irrespective of performance on key parameters like business growth, containing NPAs and controlling credit costs.
- Banks making the startling disclosure not on its own volition but on RBI lifting the veil of secrecies and manipulations, compelling the Banks to undertake Asset Quality Review (AQR) exercise as a clean-up measure. This naturally raises issues on the standards of corporate governance.
- Violation of insider trading guidelines for a listed entity by the designated officials or connected parties seized of insider information.
- Largesse to top management officials post announcement of annual results when net profit took a beating and asset

quality worsened.

- Whats App quarterly results leakage issue where SEBI had ordered an internal enquiry into the incident, causing reputation loss.
- When dividend to the shareholders is skipped by the board on account of inadequate profits or losses why incremental compensation be proposed for the top management officials.
- Board engaging a search agency for identification of a successor and suddenly announcing extension of tenure well in advance.
- Global rating agencies casting aspersion on issues of risk management and Corporate Governance.
- Senior Officials leaving/reportedly asked to leave without conducting an investigation when media reports surfaced about controversial exit, leaving a lot of questions in the mind of the shareholders than what meets the eye.
- Operative environment in Public Sector Banks (PSB), and selection process for Director level positions in PSBs to attract best board level talent.
- Delaying selection of CMD position in Public Sector Banks beyond a certain period that defers/vitiates the decision making process in the Banks.
- Introduction of performance-linked compensation through Employee Stop Option Scheme.
- Boards of the Public Sector Banks may be empowered to fill up the competency gaps at the board level, and recommend appropriate personage to the Government.

McInnes Cooper' Corporate Governance Best Practices

Right-sized governance practices will positively impact long-term corporate performance – but companies must design and implement those that both comply with legal requirements and meet their particular needs. Here are the top 5 corporate governance best practices that every Board of Directors can engage – and that will benefit every company.

1. Build a strong, qualified board of directors and evaluate performance

Boards should be comprised of directors who are knowledgeable and have expertise relevant to the business and are qualified and competent, and have strong ethics and integrity, diverse backgrounds and skill sets, and sufficient time to commit to their duties. How do you build – and keep – such a Board?

- Identify gaps in the current director complement and the ideal qualities and characteristics, and keep an "ever green" list of suitable candidates to fill Board vacancies.
- The majority of directors should be independent: not a member of management and without any direct or indirect material relationship that could interfere with their judgment.
- Develop an engaged Board where directors ask questions and challenge management and don't just "rubber-stamp" management's recommendations.
- Educate them. Give new directors an orientation to familiarize them with the business, their duties and the Board's expectations; reserve time in Board meetings for on-going education about the business and governance matters.
- Regularly review Board mandates to assess whether Directors are fulfilling their duties, and undertake meaningful evaluations of their performance.

2. Define roles and responsibilities

Establish clear lines of accountability among the Board, Chair, CEO, Executive Officers and management:

- Create written mandates for the Board and each committee setting out their duties and accountabilities.
- Delegate certain responsibilities to a sub-group of directors. Typical committees include: audit, nominating, compensation and corporate governance committees and "special committees" formed to evaluate proposed transactions or opportunities.
- Develop written position descriptions for the Board Chair, Board committees, the CEO and executive officers.
- Separate the roles of the Board Chair and the CEO: the Chair leads the Board and ensures it's acting in the company's long-term best interests; the CEO leads management, develops and implements business strategy and reports to the Board.

3. Emphasize integrity and ethical dealing

Not only must directors declare conflicts of interest and refrain from voting on matters in which they have an interest, but a general culture of integrity in business dealing and of respect and compliance with laws and policies without fear of recrimination is critical. To create and cultivate this culture:

- Adopt a conflict of interest policy, a code of business conduct setting out the company's requirements and process to report and deal with non-compliance, and a Whistleblower policy.
- Make someone responsible for oversight and management of these policies and procedures.

4. Evaluate performance and make principled compensation decisions

The Board should:

- Set directors' fees that will attract suitable candidates, but won't create an appearance of conflict in a director's independence or discharge of her duties.
- Establish measurable performance targets for executive officers (including the CEO), regularly assess and evaluate their performance against them and tie compensation to performance.
- Establish a Compensation Committee comprised of independent directors to develop and oversee executive compensation plans (including equity-based ones like stock option plans).

5. Engage in effective risk management

Companies should regularly identify and assess the risks they face, including financial, operational, reputational, environmental, industry-related, and legal risks

- The Board is responsible for strategic leadership in establishing the company's risk tolerance and developing a framework and clear accountabilities for managing risk. It should regularly review the adequacy of the systems and controls management puts in place to identify, assess, mitigate and monitor risk and the sufficiency of its reporting.
- Directors are responsible to understand the current and emerging short and long-term risks the company faces and the performance implications. They should challenge management's assumptions and the adequacy of the company's risk management processes and procedures.

**Mr. Deepak Pande is a seasoned banking, finance & investment professional with over 30 years of experience in Indian Markets. He is also a specialist across diverse banking, finance and investment products. He is former Senior Vice President, Axis Bank Ltd., graduated from IIM, Indore besides being a Certified Financial Planner and CAIIB qualifications. He is also a member of IOD.*

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