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Corporate Governance -
A framework based implementation needed

Banking regulation centrally is preoccupied with the problem of inconsistent and varying degrees of risk-taking by banks and other leveraged financial institutions, which have led to unexpected bank losses and their resulting high economic costs. In recent decades, regulators have sought to bring in regulations and laws almost exclusively through external "safety and soundness" regulations, emphasizing capital requirements, disclosure, and an intensive risk assessment process.

In recent times, banks have also been advised to have an independent risk management policy which oversees governance of the credit policy as well as the audit and financial policies. However, modern banking regulation, both in India and abroad, can't do well to make the Governance process a rigorous activity in banks and other financial institutions. Surprisingly, this is true even in the aftermath of the financial crisis, which seemed to illustrate the shortcomings of relying exclusively on external regulatory restrictions for consistent good bank performances. Policymakers may need to consider financial institution governance beyond the lens of the corporate governance literature alone. Focus needs to be beyond shareholder agency costs or promoting solutions that best-align manager and shareholder's commercial interests but ignore depositors and borrowers as equal stakeholders.

Therefore, Governance is not a defensive risk management but a proactive practice to maximize yet optimize business opportunities and partaking of prudent risk taking. It is in essence a spirit of governance embedded in the collective experience and expertise of Boards to offer leadership in prudent risk taking rather than risk control.

This paper is to give insights on how such effective proactive Governance is possible.

Lack of proper essence of risk management in corporate governance can have severe consequences on the economy. It has a negative impact on its stakeholders and also on the economy as a whole. Effective risk taking at the Board is the canter of Effective Corporate Governance.

Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system and can result in the transmission of problems across the banking sector and the economy as a whole. The primary objective of corporate governance should be safeguarding and optimizing stakeholders' interest in conformity with public interest on a sustainable basis.

The difference in corporate governance between banks and other non-financial corporates is that among stakeholders, particularly with respect to retail banks, shareholders' interest becomes secondary to depositors' interest. Therefore, Boards and Regulators have to instill Corporate Governance balancing and optimizing the interests of both.

Governance Framework proposal:

To make the essence of Risk Management distilled, the Board Governance Oversight framework is enumerated below in a ten-point broad frame-work that would achieve the above objectives:

1. **Business Strategy Review:**

- Interest rate regime,
- Market focus including sub segment focus,
- Internal prudential sub-limits for each sector,
- Macro-economic survey and review,
- Specific areas of focus in risk assessment for each industry.

2. **ALCO:**

- Duration analysis of assets and liabilities
- Arriving at Metrics of Mis-match coefficients and assessment thereof
- Identifying Business Opportunities to fix the mis-match
- Interest Coverage ratio of Deposits garnered
- Sensitivity analysis of liability asset mismatches with interest rate sensitivities
- Opportunities for more robust matching under the various above sensitivity analysis

3. **Provisioning Trend Analysis:**

- Observing provisioning trends to check if there are unusual contrary to eco system under-provisioning or excess provisioning.
- Test-check sector-wise asset provisioning against the state of health of the industry

4. **Share-holding Pattern Analysis:**

- Trend analysis to test the shareholder changes and promoter commitments to the bank

5. **Sector Specific Exposure Study:**

- Trends in sector specific exposures in the loans, changes observed.
- Alignment to the business strategy finalized.
- Industry-wise analysis of financial ratios of the listed companies in each industry company to compare with the ratios in the companies both listed and unlisted to whom the bank has exposures to

6. **Capital Raising Strategies:**

- Prudential capital levels
- Opportunities to raise capital when not in dire need
- Opportunities to bring in strategic shareholders to strengthen expertise

7. **Technology Sufficiency Assessment for Risk Monitoring:**

- Adequacy of systems for identifying transactions for end use of bank funds
- Testing robustness of sensitive module programs like for instance Money laundering transaction identifications, fund use and misuse etc
- CISA audit governance review for improvements in monitoring fund diversions and suspected unlawful money inflows into corporates (even if that is strengthening the corporate's ratios)
- New technologies evaluation for improved risk management
- Technology adequacy for data analytics to support intelligent marketing opportunities
- System robustness

8. **Data Analytics Support Adequacies for Critical Incident Review and Learnings:**

- Types of incidents that indicate monitoring or borrower systemic weaknesses (attempted fund diversions, sudden excess drawings, emergency adhoc limit enhancements, overdue renewal of limits are some types of incidents that must be reported),
- Large deposit outflows both in numbers and value to understand reasons
- Root cause analysis from a policy perspective and resolutions

9. **Root-cause analysis of Lost Lending Opportunities and also NPAs:**

What kind of businesses we lose and why? Do we lose better quality businesses to be left with hankering after lower quality businesses? What product features/interest rates etc disallow us from higher quality loans and deposits. In my mind, this is the most vital risk parameter which Risk Officers do not look at as they perceive business opportunity maximization as outside their purview. But bank casualties show this is at the heart of bank NPAs. Risk management needs to play a vital role in influencing and optimizing the right business at the right time.

Root cause analysis perspectives must shift to the learnings from our NPAs and list of critical incidents we missed seeing (focus on what went wrong than who messed up) (what layer what skill needs strengthening than which person has to be fixed)

10. External Review (Outside-in) and Evaluation of the Risk Management Governance and Improvement Measures:

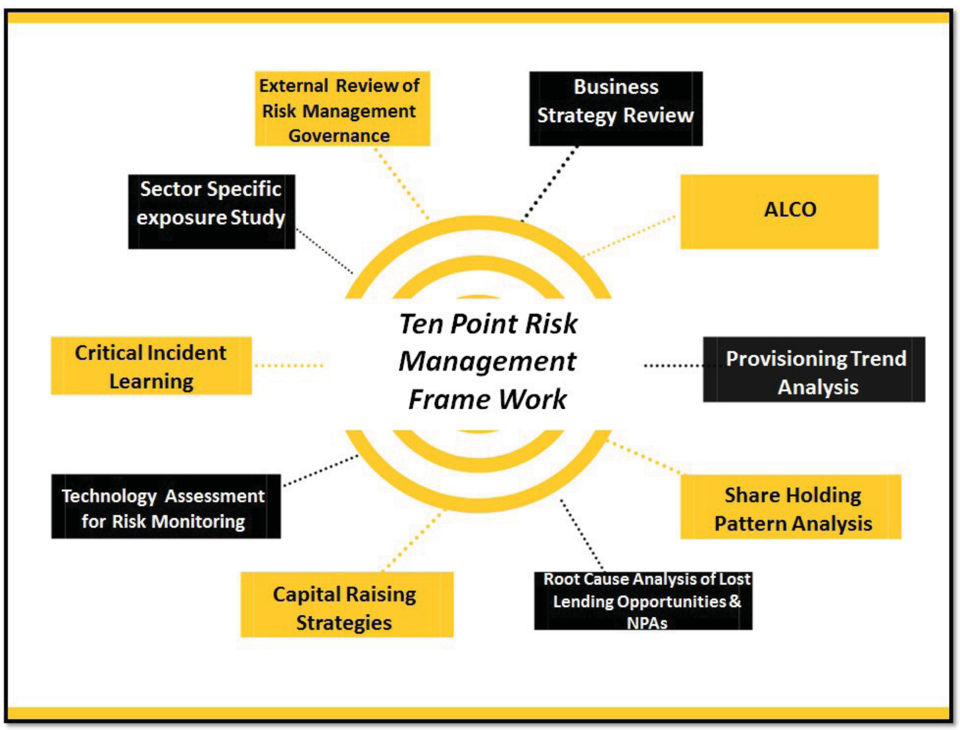
- A peer review of the Board framework of Risk management
- Share Holder ROI expectation to Depositor Protection: Sensitivity analysis to understand scope to optimize both expectations

The above ten points can be the framework for Best Practices on Governance of Risk in Banks. Recent episodes over the decade indicate opportunities for a modern implementation framework of Governance.

In sum, bank losses arises when banks do not take the good risks that are available in the market. Then they are forced to take the undue high risks to make good the lost opportunity of not taking the good risks.

Independent Directors can lend expertise to Boards by offering insights in the ten point framework above given. Experts can add depth to the ten-point framework by building more best practices case studies out of experience and fresh knowledge. In fact the tenth point (Governance Test through Peer review) is the Feedback loop of all Governance frameworks.

The ten point framework is a BPM framework of Quality of Risk Governance and therefore follows the quality loop of input-output-feedback-input (IOFI). This IOFI framework enthuses Quality and Detailing into Governance. The devil lies always in details and Details is the basis of Good Implementation. ▪



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