

# Huge conflict of interest in bank governance

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A recent RBI paper on bank governance skirts an age-old issue: The accountability of its nominee on bank boards

The Discussion Paper on “Governance in Commercial Banks” released by the RBI on June 11 is a high-quality document that contains principles drawn from those released by the Basel Committee on Banking Supervision (BCBS) in 2015.

But it skirts the significant “conflict of interest” issue involved in RBI nominees being on the boards of banks, which the regulator supervises. Perhaps, nowhere else in the world does the regulator sit on the boards of the entities it supervises.

Apart from this obvious conflict of interest, it raises fundamental and embarrassing questions on what the regulator’s nominees on bank boards were doing when later on, and unfortunately, issues of arguable lapses of board-level oversight came up.

## NPA ‘management’

The Asset Quality Review (AQR) of 2015 brought into the open a massive systemic issue of NPAs, from which the banks took at least four years to recover. It resulted in the downgrading of the asset status of accounts and, consequently, a spurt in NPAs (what the banks had shown as good accounts were found to be bad loans in plain English after the AQR by the RBI).

Strangely, no one seemed to ask then what the RBI nominees on the boards of these banks were doing when the NPA ‘management’ was going on. Account after account was restructured as a policy. Corporates would come to banks, which were totally averse to accepting the restructuring terms, saying “if you don’t approve the proposal fast, ‘your’ account will become NPA.” Mind you, it was as if the onus lay with the bankers to keep the loan good. Banks bought this thesis, not bothering to tell the corporates that “if you have borrowed, you better pay back.” The legal system for recovery was also weak.

It is my belief that in our system, the small borrower (home loan/mortgage loan/agri loan) almost always gets the short shrift while the bigger ones more often get treated with kid glove. Of course, ever since the historic and path-breaking move by the Narendra Modi government in 2016 to create the Insolvency and Bankruptcy Code, banks have regained the upper hand, hiccups notwithstanding.

## Issues with governance

Questions of governance at the board level, however, remain unanswered. “What was he/she sitting there and doing?” This is an unarticulated question applicable to the RBI nominee in the context of the pre-AQR days, and subsequent events like the Nirav Modi scam. He/she ought to be as inculpable/culpable as the other board members — and the basic anomaly is of the regulator sitting on the board itself. Therefore, it is surprising that the idea of the RBI disengaging from bank boards has not been mooted even now.

This was raised and discussed by a previous committee headed by PJ Nayak in May 2014, which stated unambiguously: “The principle that RBI as the Regulator and Supervisor of banks should not be on bank boards (and therefore not be party to bank management decisions) is unexceptional. RBI has written to the Government seeking permission to withdraw its nominees (who could either be serving or retired RBI officers, as the government ‘scheme’ requires them to have knowledge of ‘bank regulation or supervision’) from bank boards, except when there are special concerns.”

Again, it would be fair to ask: What happened to this written representation? If for any reason it has been decided to continue with the practice, it is better that it is clarified so that these “Discussion Papers” become more meaningful. Ultimately, all of us have a single goal — a strong financial sector.

It may also be relevant to recall that the current Chief Economic Advisor, Krishnamurthy Subramanian, was a member of the Nayak Committee.

The second issue is the absence of a key BCBS (Basel Committee on Banking Supervision) norm on the need to customise governance to fit the size and scale of operations. What applies to the country's banking icon, SBI, need not be applicable to a smaller bank like Karnataka Bank or Federal Bank.

Para 16 of the BCBS document states that “the implementation of these principles should be commensurate with the size, complexity, structure, economic significance, risk profile and business model of the bank and the group (if any) to which it belongs. This means making reasonable adjustments where appropriate for banks with lower risk profiles, and being alert to the higher risks that may accompany more complex and publicly listed institutions.”

It is high time we realised that the Basel norms themselves do not necessarily warrant uniform application of norms, irrespective of size.

## Transparency needed

The third and, more important, thing is the purpose, scope and transparency of the annual supervisory review/audit of banks, especially on matters of governance. The supervisory manager's report (the audit report) is wide ranging, comprehensive and is a positive tool for course correction. It has great relevance to governance and for all stakeholders, including customers and minority shareholders.

But this report's observations on board-level proceedings/oversight can at times be adverse in nature. This is an oddity, because the board has an RBI senior nominee as well. And the BCBS has clearly laid down that “in the context of board responsibilities, the term ‘oversee’ should be understood to mean ‘oversee and be satisfied with’.” So these reports can have connotations of indictments.

From a banker's perspective, it could even be asked whether with a board nominee, isn't there a concurrent evaluation by the RBI of any PSU bank's functioning anyway; and, aren't the adverse notings in the supervisory reports (especially the macro-level comments) in the nature of self-goals?

The fourth, and final, point is that there is a need to examine the allowing of transparency on the audit findings. At least, something like a summary should be in the public domain, especially in a country like India, where public ownership defines the banking sector (and the troubled private sector becomes the public sector, if history is any indication).

The customers and the public (taxpayers included) are the ultimate stakeholders. In my view, there is nothing to be lost by putting out at least a summary of the annual RBI evaluation of banks. If only it was done with, say, YES Bank, investors and depositors would have been better informed about the shape of things to come.

At present, it is not even made known within the bank concerned. Only a chosen few are privy to the RBI supervisory ratings of the bank.

The reports are not made available in its entirety even to all who are categorised as "senior management" for all other purposes, including corrective action. The organisation's compliance culture may well improve when the rank and file also know what the RBI expects them to do. All stakeholders will welcome some more sunlight in regard to the RBI's supervisory reports.

The writer is a top public sector bank executive. Views are personal

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## A letter from the Editor

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