IiAS INSTITUTIONAL INVESTOR ADVISORY SERVICES

15 July 2020

Reserve Bank of India
Department of Regulation
13th Floor, Central Office Building,
Shahid Bhagat Singh Road, Mumbai-400 001.

Attn: Shrimohan Yadav, Chief General Manager/ dpcg@rbi.org.in;

Dear Sirs:

Re: Discussion Paper on Governance in Commercial Banks in India

We are writing to give our suggestions and comments on the discussion paper on 'Governance in Commercial Banks in India' released by the Reserve Bank of India on 11 June 2020.

We are a SEBI registered research entity dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for about 800 companies that account for about 95% of market capitalization.

We recognize that this discussion paper focuses on the need of a strong governance framework and the development of a well-defined risk governance framework, greater accountability of the board of directors and a detailed structure for board committees.

1. **No carve outs or exceptions for public sector banks:** Public sector banks account for over 60% of banking assets. We argue that allowing them a carve out will defeat RBI's purpose of improving the corporate governance structures in commercial banks. We believe that the role of independent boards in fostering the culture and values of banks by establishing the proper systems of control, audit and distinct reporting of business and risk management is found wanting in most PSBs, leading to build-up of NPAs. PSBs need a diversified board structure with cross-functional expertise including in the field of information technology, risk and markets. The current process of receiving nominations and appointing directors needs to be overhauled. There must be a rationalization and strengthening of board level committees for improved governance. RBI should have used this discussion paper as an opportunity to ensure that the rules for governance of public sector banks.

2. **Role clarity and focus on quality of directors:** Based on a reading of the report, it is unclear what the roles and responsibilities of the executive management are, what the roles and responsibilities of the board are and even what the responsibilities of the RBI as a supervisor are. These need to be clearly delineated so that there is no ambiguity regarding accountability.

Like the RBI, we strongly believe encouraging banks to appoint the right mix of qualified directors will have a more material impact on their governance. This report too has not provided any evidence or made a durable case, that placing more responsibility on the board is likely to improve the quality of governance of banks.

By way of example, the government owned banks in addition to being audited by the regulator have numerous other audits: concurrent audit, internal audit, statutory audit, credit audit, risk-based internal audit, revenue audit, information systems audit, snap audit, segment audit, compliance audit, legal audit, FEMA audit, management audit, foreign office audit (- if needed), audit of outsourced services., etc. These have not led to an improvement in the bank's performance, but rather focused attention away from business issues. The several audits and oversight measures have not stemmed fraud losses in public sector banks eithers.

3. **Accountability of the CEO vis-à-vis board committees:** RBI has identified the control functions - the risk management function, the compliance function and the internal audit function, to provide objective assessment, reporting and/or assurance.

   RBI needs to clarify that while these businesses are accountable to the board, the CEO is still administratively responsible for these: put differently this means that the CEO needs to ensure that these are properly set-up, have well defined SOP's, properly staffed with adequate resources at their disposal. Further the CEO needs to be a part of their functioning and conclusions.

   On specific board committees, there is a strong case to have executives present and including the CEO be a part of the risk committee. This function lies at the core of all banking activities, the senior management bring a practitioner's perspective that may not always be available with the NEDs. And finally, I am sure RBI will want the CEO and senior management to benefit from the richness of the discussions and debates that will take place in these committees.

   The nominations and remuneration committee is tasked with deciding both the compensation and selection of the board members, the CEO, and heads of the control functions. RBI should consider breaking up the two roles for greater clarity. Both the chairman and the CEO need to be a part of the process for senior appointments. CEOs should have a role in assisting the board in choosing their successor and the leadership team.

   We believe that it is imperative that promoter CEOs be closely associated with CEO selection: you do not want them to publicly vote their shares against the potential successor/candidate, as this may end up being extremely disruptive and lead to all kinds of dysfunctionality in the functioning of the bank.

   Regarding remuneration, the committee can have a decisive say on the salaries in the 'assurance functions, but these need to be in line with the pay structure of the bank. As regards those reporting to the CEO, the proper practice is for the compensation committee to ask questions and correct this, if they believe the CEO is being unfair or overly generous to a select few. But as the impact of the decisions taken in this committee will be on the salary

of employees down the line and the cost structures of the bank, the CEO needs to be involved.

4. **Tenure of the CEO:** In setting a cap to the absolute tenure, we recognize that RBI is signaling the need to institutionalize banks and prepare for succession. CEOs/WTDs of banks are generally approved by shareholders for a tenure of five years and their reappointment comes up for shareholders' approval. This ensures shareholders have a say on CEO reappointment. Further, RBI approves a CEO's reappointment and remuneration for just three years at a time. Because RBI closely monitors banks, it is also well placed to understand the bank's practices and decide if the bank needs a leadership change. Thus, the current system of CEO reappointment has sufficient checks and balances and does not need another layer of a tenure cap. We advocate that RBI make the tenure cap recommendatory, but not mandatory.

   We strongly advocate that the proposed recommendation should also apply to public sector banks. CEO rotation in PSBs is generally much too soon, with almost all CEOs holding their term for less than three years, not giving them a chance to contribute to the bank's growth. Reserve Bank should work with the Government of India, to ensure that CEOs of PSU Banks have a tenure of at least five years.

   We also believe that the current practice of disclosing to the public the set of names sent to the Reserve Bank of India, discourages high quality talent from applying to banks for the CEO and other senior roles. The public disclosures of these names should be immediately discontinued.

5. **Executive compensation disclosures - Pay vs Performance:** All banks must provide detailed disclosure of performance metrics used to determine the pay of their senior executives. Global banks such as HSBC (pg 184-210) and Standard Chartered Bank (pg 108-127) disclose detailed performance review of their executive directors by outlining their performance against the targets set. These include details on revenue growth, effective management of material operational risks, improved productivity, effective execution of agreed plans for corporate development as well as achievement of sustainable global conduct outcomes and effective financial crime risk management.

6. **Board Attendance:** IiAS believes that attendance of directors in board/committee/ shareholder meetings is a critical indicator of their commitment towards the bank, its governance and performance. We believe that the directors should strive to achieve 100% attendance at board meetings and take advantage of technology in terms of telephonic or video conferencing when there are unavoidable circumstances preventing them from physically attending the meetings. Nevertheless, we recommend that if a director does not attend at least 75% of the meetings held in a financial year, his/her continuance on the board will need to be ratified by the shareholders at the next annual general meeting. This will ensure more accountability of the directors towards the board and shareholders.

   Further, the stipulation that the board is to meet at least six times, and once every sixty days limits the bank's flexibility. We believe that the number of meetings should be left to the

banks board – or at the very least the gap between meetings be increased to eighty days to give banks the necessary flexibility.

We note that RBI has made a lot of effort to prepare an exhaustive list the various aspects which they want the boards to oversee: this may lead to a check- box approach to governance, which we understand, is not in line with RBI's thinking. Further, given that it is not possible to envisage all the situations ('the unknown unknowns'), RBI may wish to reconsider its approach by listing the broad principles that it wants the boards and directors to run the bank on. We believe that such an approach is more likely to succeed going forward, than it has in the past, as banks face greater market scrutiny and now make more streamlined disclosures. We urge RBI to rethink this aspect before it finalizes its instructions in this regard.

We thank RBI for this opportunity to share our views and hope you find our comments useful. If you need clarification on any of the comments, do let us know and we will be happy to discuss our comments at your convenience.

Yours sincerely,

SIGNED

Amit Tandon
Managing Director