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SHAPE UP OR STAY PUT?

Bank Boards beware. Mint Street has spoken.

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RBI needs to be complimented for a long overdue initiative, namely, getting all Directors into one room and highlighting what Boards need to do to improve Corporate Governance. As Alexander Pope observed "Hope springs eternal in the human breast." When it comes to promoting governance, can SEBI be left behind?

The first ever conference of Directors on the Boards of banks, both in the public sector and in the private sector, was organised by the Reserve Bank of India (RBI) in May, 2023. These were in reality two different conferences, held a week apart. The commonality was that both the Governor and Deputy Governor, Mr M Rajeshwar Rao, delivered the same speeches to both these audiences, while making it clear that there were aspects that did not apply equally to public sector and private sector banks.

There can be no doubt whatsoever that a conference of this kind is a welcome initiative in which the Directors not only get to hear first-hand the views of the Governor and the Deputy Governor, but have the opportunity to raise questions directly. Since there is no public record of the issues that the Directors might have raised, we will confine our attention only to the two speeches that set the tone for discussions.

While taking note of the strong and stable position in which the banking sector finds itself, the Governor cautioned that it is in such times that complacency might set in. In that context, he exhorted the Directors on the Boards of banks to discharge their responsibilities, giving special attention to the protection of the money of depositors.

The overriding concern that any keen observer of the Indian banking sector, especially the public sector banks, might have is whether the Directors presently on the Boards can, and will, measure up to these challenges. The expectation that the Board, being at the apex of decision-making, should set a clear direction for the management, is rooted in sound Corporate Governance theory. This is premised on the fact that Directors are chosen to be on bank Boards based on what the Governor described as "a balanced combination of skills, diversity and expertise". Having regard to the selection process, in which bank managements or the Boards were not involved, it would take considerable optimism for any person to believe that the skills, diversity and expertise required for a person to be on a bank Board actually exist, if not wholly, at least in part, among those who have been appointed. Unless bank Boards are appropriately constituted, with the right kind of persons being brought on them, it would seem unreasonable to expect that they would deliver in regard to the tasks identified for them by the Governor.

Speaking of the independence of the Independent Directors (IDs), the Governor has very clearly articulated what his expectations are. He observes “it is necessary that ‘independent’ directors are truly independent; that is, independent not only of the management but also of controlling shareholders while discharging their duties”. In the public sector banks, the controlling shareholder is the Government of India. There is not enough evidence to show that IDs on bank Boards will disregard the overriding influence that the Government of India, by virtue of its majority shareholding, brings to bear on the functioning of banks.

Speaking of the role of the Chairpersons, the Governor has observed that they “should encourage open and honest discussions, which, at times, can be critical of the proposals recommended by the management”. The Governor also states that “fostering an environment where dissenting views can be freely expressed and discussed is what will ensure objectivity”. One wishes he had used the words “different views” or “divergent views”, and not “dissenting views”, since some Directors might be inclined to read into this sentence the suggestion that dissent should be frequently expressed and recorded. The impact that this can have on the cohesiveness of the Board, does not require elaboration. Cohesive Boards are necessarily collusive Boards.

Speaking of the MD and CEO, he has expressed the view that the “dominance of CEOs in Board discussions and decision making” has been noticed on occasions. While indicating clearly that situations, in which the Boards are not asserting themselves, should not be allowed to develop, he goes on to state that there are also situations where “the CEO is inhibited from doing his duties”. This concern can be addressed if the respective roles of the Chairperson and the MD are clearly understood by both of them, and by the rest of the Board, and the management. It is lack of role clarity that often gives rise to situations of passive coexistence or active aggression. The ideal Board-management relationship should be one of constructive tension, and if that is understood, appreciated and practised, the apprehensions expressed in this context by the Governor will get addressed.

Referring to the quality of information made available to the Board, the Governor has expressed concern on “gaps and material inaccuracies” in Board notes. He has also identified the delayed circulation of agenda papers as a contributing factor to the underperformance of the Board. These are matters in regard to which the Board should assert itself. If the information is incomplete or incorrect, the Board should point it out to the management, so that instances of that kind do not recur. There is also a need for senior management to be trained in the manner in which agenda notes should be crafted to make them aids to decision-making by the Board. Referring to “only powerpoint presentations being circulated as agenda notes”, the Governor rightly observes that “powerpoint presentations are like a guided tour, and Directors should clearly look beyond a guided tour”. In concluding thus, the Governor has been charitable to bank managements because often the powerpoint presentations are not sent out in advance, and are seen by Board members only when they are actually presented. Considering that making effective and meaningful powerpoint presentations is not a strength manifested by many of the managements, this too is an area that merits significant training inputs. This author has often stated, by amending Lord Acton’s statement that “power corrupts, and powerpoints corrupt absolutely”. Many Directors are prisoners of powerpoint presentations, and the more colourful they are, the more their attention gets diverted from the content of the presentations.

For effective oversight of senior management, the Governor notes that their performance and compensation should be evaluated. The present inhouse attempts at evaluation fall significantly short of being a value-adding exercise. Compensation, in any event, is so meagre that it is unlikely to attract the best persons to the bank Boards. Therefore, there is the opportunity for those who are “willing, but not able” to seek to occupy Board positions, a development that will be to the serious detriment of a performing bank Board. The related point which the Governor makes is that “a compensation structure which does not distinguish between prudent risk taking and excessive risk taking often results in a culture of indifference towards risk taking”. In an environment in which errors of commission are punished, and errors of omission are ignored, it would be difficult to move the average Director away from the relative safety of not participating in, or contributing to, decision-making. Unless a climate is created in which honest decision-making is encouraged, banks will continue to suffer suboptimal contributions by the Board as a collective. Risk taking is central to the business of banking, and bankers ought to be emboldened, empowered, encouraged and incentivised.

Concern has been expressed in regard to instances where the integrity of financial statements has been compromised, and “so called smart accounting methods were adopted to artificially boost the financial performance of the bank”. The question necessarily arises whether practitioners of such “smart accounting methods” were held accountable, and whether auditors were questioned as to why they chose to look the other way when these methods were resorted to. The NFRA’s circular of June 26, 2023, reminding statutory auditors that they should exercise professional scepticism, is a timely wake-up call.

In conclusion, the Governor has stated "Governance frameworks can be pictured as a complex mesh of nuts and bolts holding the financial pillars of capital, assets, deposits and investments in place and keeping the structure of the bank upright". If the expectation is that the Boards, as presently constituted, will deliver on this count, it is a very big ask.

In his speech at the same conference, the Deputy Governor has referred to steps taken by the RBI from time to time, based on reports of various committees setup by the RBI to improve governance in banks. One particular comment made by him is reproduced below because it gives rise to a major question. "The governance framework set out by the Board should ensure that the three lines of defence do the job as expected – much like in the game of football, where the forwards, the midfielder and the defenders should collectively keep the ball in play and ensure that the supervisor as a goalkeeper is not engaged". With great respect, the analogy could cause problems. If these three sets of players keep the ball in play, no goals would be scored, and we could end up having boring goalless draws. What is even more significant is that he has envisaged the supervisor as a goalkeeper, who is not to be troubled. If the RBI, as a supervisor, is not to be troubled in its role as a goalkeeper, the question arises whether the RBI as a Regulator is the referee on the football field, armed with remedial powers, and the ability and more importantly, the willingness to blow the whistle at the right time.

The major ills of public sector banks are at least partly owed to the number of enactments, rules and regulations which apply to them. Around 30 years ago, the then banking Secretary, Dr Venugopal Reddy (autocorrect sometimes gets it right by spelling Venugopal as venerable) recommended that there should be only two laws for the banking sector, one dealing with the ownership function, and the other dealing with the conduct of business. In a sense this anticipated the problem that the Companies Act, 2013 sought to address by providing that wherever there are sector specific enactments, they will, in the event of inconsistency, prevail over the provisions of the Companies Act, 2013. This has led to non-applicability of important sections of the Companies Act, 2013 to the banking sector, and has also resulted in exemptions being granted in regard to important matters such as Board evaluation. Even the composition of the Board is not in sync with the provisions of the Companies Act, 2013, and for banks which are listed entities, the prescriptive arrangements get somewhat lighter. Having brought governance centre stage, the RBI should ideally push for the Companies Act, 2013, and the Banking Regulation Act, 1949 being the only two enactments relating to banking.

Meanwhile, SEBI has amended the SEBI LODR Regulations for the 34th time.

As firm believers in the continuity and certainty of laws and regulations, we have often tended to ask the following questions whenever any amendments have been proposed or have surfaced. Was this amendment necessary? Will it solve the problems that it seeks to address, or will it create additional problems in search of solutions?

The SEBI LODR (Second amendment) Regulations, 2023 is a case in point. While it addresses several aspects of some of the Regulations, the focus in this assessment has been on some of the more important issues.

Regulation 2(ra) seeks to define "mainstream media". The definition is so exhaustive as to give rise to the question whether there is any such thing as non-mainstream media, or in other words, whether all media, other than social media, is mainstream media.

A new insertion, Regulation 6(1A) provides for the manner in which any vacancy in the office of the Compliance Officer shall be filled. The outer date for filling the vacancy is 3 months from the date of such vacancy. What is significant is that the proviso to the new Regulation states that "such vacancy shall not be filled by appointing a person in interim capacity, unless such appointment is made in accordance with the laws applicable in case of a fresh appointment to such office and the obligations under such laws are made applicable to such person". The choice before the listed entity is clear. Either leave the vacancy unfilled for a period not exceeding 3 months, or find a suitable candidate with all the appropriate qualifications to be regularly appointed, and appoint him/her in an interim capacity. This proviso does not address the possibility that there might not be another person in that listed entity who is suitably qualified and can assume such office. Would it not be a preferable option to have a relatively suitable person from within the company appointed on an interim basis, rather than to leave the position of Compliance Officer vacant for 3 months?

Regulation 26A regarding vacancies in respect of certain Key Managerial Personnel suffers from the same problematic choice. Would It be preferrable to leave vacancies in the office of Chief Executive Officer, Managing Director, Whole-time Director or Manager vacant for a period not exceeding 3 months, or would the interest of stakeholders and the company be better served by appointing in an interim capacity, the most suitable of the available persons, even if he/she does not tick all the boxes?

Regulation 30(4) has been expanded to indicate the basis for determination of materiality. The new insertion provides that where the criteria specified in subclauses a, b and c are not applicable, an event or information may be treated as being material if in the opinion of the Board, the event or information is considered material. What then is the purpose of listing three sets of criteria in order to determine materiality?

A new insertion, in the same regulation, states, by way of a proviso, that a policy for determination of materiality shall not dilute any requirement specified under the provisions of these Regulations. It is not easy to comprehend how a policy formulated by a company can override the provisions of any Regulations.

The icing on the cake is the requirement that the top 100 listed entities wef October 1, 2023, and thereafter the top 250 entities wef Apr 1, 2024, shall confirm, deny or clarify any reported event or information in the mainstream media, which is not general in nature, and which indicates that RUMOURS (emphasis supplied) of an impending specific material event or information are circulating amongst the investing public. Before looking at the specifics, it might be useful to recall that Shakespeare's definition of a rumour is "a pipe blown by surmises, jealousies and conjectures". Are these the kind of rumours that ought to be given disproportionate importance, leading to detailed rebuttals or confirmations? What, if any, would be the implications in regard to leakage of unpublished price sensitive information (UPSI), leading to premature disclosures? One instance from a few years ago will help to illustrate the concern. During a conference relating to the telecom industry, very senior functionaries of two telecon giants coincidentally stepped out of the conference room at nearly the same time, and exchanged pleasantries, while heading for the coffee counter. A television channel speculated on whether that brief conversation signalled the beginning of a possible merger between the two entities. This author had occasion to ask the concerned television correspondent whether there was any basis whatsoever to the rumour, and the response was laughable, to say the least. It was on the following lines – "Should such a merger happen in the future, please remember you saw it first on my channel". If this is the responsibility attached to floating rumours, there would not seem to be enough justification for corporates to bend over backwards to confirm, deny, explain, contradict or rebut them. Like everything else, will increasing disclosure requirements take us to a point where the possibility of damage is far more than the benefit sought to be achieved? As has been mentioned earlier, while sunlight is the best disinfectant, sunburn would be harmful.