Communication

Functioning of Boards in PSBs in India

Sunil Kumar Maheshwari & Ramesh Bhat

Introduction

This communication is based on the experience of four independent directors, including the authors, participating in the boards of various PSBs. It highlights serious systemic issues in the functioning of the boards. It has significant implications for the selection and assessment of directors on the boards of PSBs.

The recent fraud of a whopping Rs. 113 Billion in Punjab National Bank and many more defaults by large corporates has brought the focus on the functioning of public sector banks (PSBs). While PSBs were struggling to cope with gross non-performing assets (NPAs) and stressed loans under corporate debt restructuring (CDR) of nearly 20%, recent realization of systematic frauds over the years has made the situation very precarious for them. One cannot rule out many more undiagnosed frauds that might have happened in last few years. The common man in the country is fuming and tax payers are crying foul on such developments.

In the recent past asset quality review (AQR) initiative of Reserve Bank of India (RBI) was an attempt for cleaning the balance sheets of banks. However, it has caused stress in banks to maintain statutory liquidity. There have been different estimates of NPAs in different studies. Based on two stints in the boards of two different PSBs, we estimated that NPAs and CDRs in banks in India could be in the range of Rs 10 lakh crore and 14 lakh crore. Closure scrutiny of these accounts is likely to reveal larger malaise in the system. Such deteriorating asset quality indicates the problems with the governance of PSBs, especially the role of board members, top management, auditors and control systems.

The ability of a top-management team to assure the control of its organization is a fundamental concern for share holders. Agency theory is behind the idea that corporate managers should make shareholder value their primary concern, and that the boards should ensure they do. This is of high significance when ei-

Sunil Kumar Maheshwari **(Email:** sunilm@iima.ac.in) is Professor (Human Resources Management Area), Indian Institute of Management Ahmedabad 380015. ***Ramesh Bhat*** **is** Provost and Dean, NMIMS, Mumbai

ther the ownership of large corporations is dispersed among thousands of stockholders or it is held by the governments in a democratic setup. It is difficult to identify and isolate individuals who truly assume the role of principals in these two types of organizations. Hence, the role of boards assumes larger importance to ensure non-shirking of responsibility by managers in PSBs in democracies like India.

It is in this context this communication was undertaken. The first author has served on the boards of two large PSBs. He systematically kept notes about the time spent by board members in the discussion of agenda items in board meetings. He also interviewed three independent directors on the boards of other PSBs. Collectively he and other three directors had served banks in the tenure of five different CEOs of PSBs.

Each interview was focused on identifying the reasons of NPAs, role of the board, relationship with auditors and the way board meetings were conducted in PSBs. Based on the interviews and first author's notes and observations, a detailed note was prepared and shared with the officials in Ministry of Finance. The first author also shared his findings with the Governor, Reserve Bank of India (RBI) and a few top officials in PSBs. Comments were sought from them. None of them mailed their comments to us.

We present our findings with the aim to further strengthen the governance in banking Industry. The paper has strategic implications and assumes special significance in the current environment characterized by frauds, NPAs and vulnerability of PSBs. More is demanded from board members, especially the independent directors, than ever before. They are expected to ensure their banks' compliance with regulations, warn any wrong doing, and assure shareholders.

Observation 1: Functioning of Consortium and Joint Lending Forums (JLFs): The proposals for advances are often not examined thoroughly by consortium members. It is observed that regularly proposals without adequate analysis reach the top level for approvals. Industry analysis is rarely undertaken in a scientific manner yet they get approved by many members of the consortium. These proposals, agreed to in the consortium, are presented to boards. At times board members identify serious flaw in such proposals. Yet they are persuaded to agree and comply with JLF/ consortium. Borrowers with ill intentions often manipulate management. These borrowers would often collect conditional sanction letter (subjected to others agreeing by this). Other banks also tend to fall in line and advances are sanctioned without meeting of members of the consortium to take a collective decision.

Observation 2: Objective of CC Limit: Cash Credit (CC) system was introduced in 1976 to help organizations manage their shortfalls in working capital during the upswing of the business cycle. We observed that CC is no more seasonal in nature and remains drawn all the time. This increases the risk of default. Currently CC system is balance sheet based financing. Borrowers adjust balance sheets for meeting the need and ensure lending.

Letters of Credit (LC) along with shell companies are often used for money laundering by many business houses, as seen in the recent fraud in PNB. Boards are not in a position to detect such diversion of funds unless they get access to such information by a specialized agency.

Observation 3: Shareholder's Nominees on the Board: Boards have representation of various stakeholders, including shareholders, to ensure balanced functioning of PSBs. Shareholders' nominees are expected to protect their interests by being vigilant against any wrongdoing by executives. In reality, shareholders' nominees are rarely true nominees of the shareholders. Government, being the major shareholder, does appoint representatives on the board. However, they often are unable to attend board meetings owing to other official engagement. For similar reasons, their preparation for board meetings is generally inadequate.

There is provision for representation of other than government shareholders too. However, small investors have little voice in nominating and selecting the directors. There is significant information asymmetry and selection process complexity to have true representation of the small investors. Consequently, management of the bank plays an important mediating role in getting the shareholders' nominee directors on the board. This also influences the subsequent role of these directors. It is not uncommon when these shareholders' nominees do not fully represent the interests of the small shareholders.

Observation 4: Independent Directors Nominated by the Government: There are a few independent directors, nominated by the Government on the boards of PSBs. It is observed that Government rarely invites them to get feedback or to share their concern. They are often seen to struggle to find ways to share their observations with concerned officials. The first author often sensed possible conflict of interests amongst the chartered accountant (CA) directors owing to their services to private clients.

It was observed that the banks tend to ignore or delay the suggestions of board members other than the representatives of Ministry of Finance and RBI. In one instance, the first author's repeated advice to transfer officials after every 3 years was resisted by citing cost implications. In another instance, suggestion of putting the names of willful defaulters on bank's website was resisted by the bank.

Observation 5: Too Many Meetings: Given the regulatory and other business compulsions, the boards of PSBs meet up to 12 times in a year. Further, some of the members in different committees (especially the Management Committee) meet equal number of times in those committees. Each meeting consumes at least 2 days, including traveling time. Hence a member spends anywhere between 25 to 50 days in meetings and traveling for board meetings. Additionally, every meeting requires at least one day of preparation. Hence, actual time on board meeting would be 50 to 75 days in a year. Professionally active individuals are likely to find it tough to sacrifice the opportunity cost of this time on a sustained basis. The directors are likely to seek adequate returns for their time. Consequently, their preparation for board meetings is often found to be inadequate.

Observation No. 6: Too Little Interaction with Top Management Team: It is generally recommended that board members should arrive for the meeting one day in advance and freely interact with the members of the top management team. This rarely happens with most of the board members. There is general reluctance among the top-level managers to freely interact with board members. Further, some board members are also reluctant to arrive one day in advance for meetings, as they would have already committed too many days for board meetings. It is also observed that board members are often not supported, if they take initiatives to meet senior management members.

Observation No. 7: Too Many Compliance Items: Too many regulations and compliances, notified by RBI, have increased the number of items in any board meeting. Despite such added items, boards conduct its affairs in limited time. It is not uncommon when agenda items running into hundreds of pages are discussed in 1- 2 hours. Consequently, even important agenda items that might address future concerns often do not get adequate attention of board members. The first author rarely found CEOs of banks to encourage long discussions on items. For example, only one CEO out of 5 of them in this study was found to encourage free discussion in the board meetings. In other instances board members were asked to move forward very fast.

Observation No. 8: Lack of Information: There are two equally effective ways of keeping a board in the dark. One is to provide them with too little information. The other is to provide excessive information. Board members receive bulky documents of information in advance of each board meeting, which is too difficult to absorb and could not be properly understood without considerable background information. Board members in banks often feel confused by excessive data. Insignificant numbers and documents often overwhelm board members but it is not uncommon when documents fail to provide right information in proper form to produce informed choices.

Certainly, boards face a huge information challenge. The problem is compounded as most of the agenda papers are delivered hardly a few days in advance. These agenda papers carry information, as decided by the top management. For example, in one instance, the first author observed that JLF had not taken cognizance of the stock audit report and Techno Economic Viability (TEV) study in an important proposal. When it was raised in the meeting, officers were instructed not to provide stock audit report in proposals, as it was construed as micro-management.

Observation No. 9: Voice of Dissent: Even a single dissenter can make a huge difference in a board meeting. Often, a lone dissenter forces boards to reconsider near unanimous decisions. However, often it was observed that dissenters were discouraged.

Observation No. 10: Role of Chairman vis-à-vis that of Managing Director: It is common to observe chairman, who also happens to be the managing director, facing a dilemma. CMD in his/her role as chairman executes leadership role in the board and encourages members to contribute by inviting different viewpoints. Simultaneously, while accepting or rejecting the suggestions of the board members, CMD is likely to be concerned with the implementation challenges in his role as MD. It is not prudent that the agenda for the meeting is approved by the CMD to be later taken up by the board that is chaired by him/her. How will CMD, as the chairman of the board, reject his/her own item without undergoing some anxious moments? One is likely to get unconsciously committed to the items' approval. Ideally the items could be proposed by MD/ED and be approved or rejected by the chairman based on the advise of the board members.

This position has changed in some of the banks with recent reforms. However, appointments of chairpersons need to be expedited. It is not advisable for MD and CEO to undertake the role of chairman. In his/her absence, the role of chairman could be assigned to senior most independent director,

The Way Forward: The public sector banks have much strength. However, recent developments have shattered the faith of people in PSBs. In this context, the following are suggested:

1. Few Additional Sub-Committees of the Board: The Board is large enough to divide the responsibilities. It will be useful to have following permanent sub-committees of the board on:

a. Large borrowers' account committee to review the risk, recovery, and audit.

b. Human Resource Management: It is one of the critical areas of concern in most of the banks. A sub-committee with an expert in the field of human resource management may be constituted. This committee must ensure implementation of HR systems like transfer of officials.

c. Compliance: This committee could look after statutory compliance. This would enable boards to spend time on matters of operational and strategic importance.

2. Performance Assessment: It is recommended that performance of board members be evaluated. RBI can create a panel of high performing directors. Those on the panel of RBI may not have restriction on number of terms in PSBs' boards. Similarly, board members with poor performance rating should not be given second term. Independent agencies may be assigned this task and parameters might be fixed for this purpose.

3. Meeting the Government Nominees: It is strongly recommended that Government or RBI should meet independent director, nominated by Government, at least once in a year.

4. Independent Directors to Officiate as Non-Executive Chairman: As suggested earlier, independent directors can be assigned the role of non-executive chairman till the regular appointments of chairpersons of banks.

5. Review some of the Important Management/Operating Practices in Banks: Some of the practices in banks need immediate review. They are :

a. **Review Cash Credit System:** CC System is balance sheet based financing. We need to shift to cash flow based financing.

b. **Hypothecation**: Many of the clauses of hypothecation deed signed at the time of CC finalization are currently not followed. For example all transactions need be routed through the cc account. There is rampant diversion.

c. **Objective of CC Limit:** The cc credit is no more seasonal in nature and remains drawn all the time. This increases the risk of default. We need to make sure that it gets cleared at least for some period during the year after taking care of core part of working capital.

d. **Term Lending:** The banks have limited expertise in term lending. Most of the time they depend on project reports prepared by outsiders. This creates a serious moral hazard problem. It is advised to create specialized teams of high integrity for this purpose.