Study on the State of Corporate Governance in India

Gatekeepers of Corporate Governance – Reserve Bank of India

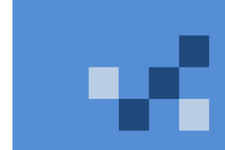
Kshama V Kaushik
Rewa P Kamboj

Indian Institute of Corporate Affairs

Thought Arbitrage Research Institute

Indian Institute of Management Calcutta

E-mail: contactus@tari.co.in; Phone: +91 11 41022447; +91 11 41022448;
Address: Thought Arbitrage Research Institute; C-25, Qutab Institutional Area, New Delhi – 110016



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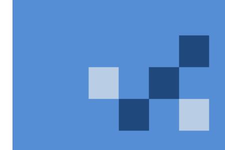

Executive Summary

This section examines the role of a major regulator, the Reserve Bank of India, which is the banking regulator in India.

Globally central banks have performed roles of currency authority, banker to the Government and banks, lender of last resort, supervisor of banks and exchange control (now it would be more appropriate to call it exchange management) authority. Generally, central banks in developed economies have price or financial stability as their prime objective and are often characterised by nearly complete autonomy.

However, in developing countries the central bank plays a bigger role in the economy and cannot reasonably be expected to have a total hands-off approach or be totally independent of government.

Central banking functions in India are carried out by the Reserve Bank of India since independence by taking over the erstwhile Imperial Bank of India formed in 1935.

RBI plays a leading role in formulating and implementing corporate governance norms for India's banking sector. The ambit encompasses safeguarding and maximizing the shareholders' value, upholding retail depositors' risk and stabilizing the financial system so as to conserve the larger interests of the public.

RBI performs corporate governance functions under the guidance of Board for Financial Supervision (BFS). BFS inspects and monitors banks using the 'CAMELS" approach (Capital adequacy, Asset Quality, Management, Earnings, Liquidity and Systems & Controls). These corporate governance norms follow a three-pronged approach of a) Disclosure and Transparency, b) Off-site surveillance, c) Prompt corrective action.

We have analysed financial information of banks which constitute 70% of total capital and reserves of the banking sector for a period of 5 years to examine whether RBI-prescribed corporate governance norms are effective.

We conclude that RBI is an effective and efficient regulator of the banking sector and a good gatekeeper of corporate governance in the sector. However, our study was restricted to the study of RBI's effectiveness in regulating only the banking sector. There are several instances where RBI seeks information directly from the commercial sector and can therefore enforce checks and balances to instill good corporate governance. RBI's effectiveness as a gatekeeper of the corporate world directly is not covered here and is the subject of further research.

Literature Review

Gatekeepers are individuals, institutions or agencies that are interposed between investors and managers/owners in order to play a watchdog role to reduce agency costs. If gatekeepers are absent or do their job inefficiently then, it is reasonable to believe, there will be fewer checks on managers/owners to behave in a manner consistent with placing investors' interests above self-interest. In other words, market efficiency will be lower which, in turn, would raise the cost of capital.

Kraakman (1986) defines gatekeepers as 'parties who are in a position to prevent misconduct by others by withholding their co-operation'[1].

Scholars like Kraakman and Coffee further define gatekeepers as reputational intermediaries who provide verification and certification services to investors. But they also acknowledge that the role of gatekeepers as reputational intermediaries who can more easily be deterred than the principals they serve has been developed in theory but less often examined in practice.[2]
Gatekeepers essentially assess or vouch for corporate clients' own statements or a specific transaction—if this sounds like duplication, it is; however, this duplication is necessary because it is generally accepted that a gatekeeper has a lesser incentive to lie than the client and…regards the gatekeeper's word as being more credible[3].

Hamdani defines gatekeepers as 'parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities'[4].

Therefore, bankers, auditors and analysts are gatekeepers for clients wishing to enter the capital market. Extending the argument, for clients who wish to raise money through shares, the capital market regulator (Securities Exchange Board of India) is a major gatekeeper. Lending to the corporate sector is one of the main planks of a commercial bank; therefore, the banking sector regulator (Reserve Bank of India) is another gatekeeper to ensure corporate governance through the regulatory mechanism of prudential lending norms and monitoring use of money, among other things.

Having a network or series of gatekeepers is, however, no guarantee that corporate wrongdoing will be detected or avoided. In a wave of corporate scandals starting from Enron, we have seen instances of multiple gatekeeping failure in which wrongdoing went undetected through several layers. 'The failure of this network of gatekeepers was a recurring theme in business scandals. In too many instances, the gatekeepers in pursuit of

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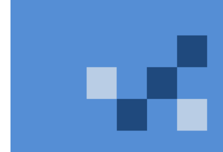
[1] 'Gatekeepers: Anatomy of a Third-party Enforcement Strategy', Kraakman, R.H., Journal of Law, Economics and Organisation 2, 53-104
[2] 'The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting', John C.Coffee, Jr., May 2001, Columbia Law and Economics Working Paper No.191. available at SSRN:http://ssrn.com/abstract=270944
[3] 'Understanding Enron: It's About the Gatekeepers, Stupid', John C.Coffee, Jr., Columbia Law School, page 5
[4] 'Gatekeeper Liability', Hamdani, Assaf, Southern California Law Review, volume 77, page 7, available at SSRN:http://ssrn.com/abstract=466040.



their own financial self-interest compromised the values and standards of their profession in the recent round of corporate scandals, the first tier—the managers—failed and then the gatekeepers failed as well'[5]

In fact, some scholars believe that, theoretically at least, the services of gatekeepers can be performed either from within or outside the corporation[6]. Of course the law mandates that certain gatekeepers must be external to the organization such as auditors but there are other gatekeepers like lawyers or internal auditors who may serve their function just as effectively if they worked from within the corporation.

Accountability of a gatekeeper requires a certain quantum of liability s/he must bear. As far as individual gatekeepers are concerned (such as auditors, lawyers, etc.), every country has some rules to punish errant behaviour. However, there are few (if any) instances of accountability of gatekeepers who are institutions; for instances, if SEBI or RBI fails to detect or deter abuse of governance norms by companies or banks, the investor has little recourse to hold them accountable. Gatekeepers' liability may not always be created for the gatekeepers' own ways—although this is also a possibility—but for the wrongs attributed to the corporation that could have been deterred or at least minimised by precautions taken by gatekeepers.

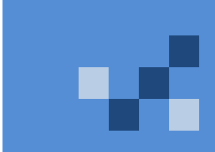
Andrew Tuch's study shows that incentive problems will arise if gatekeepers are not capable of bearing the full liability imposed on them. In other words, gatekeepers' incentives to take precautions are diluted where they are protected from full liability arising from their activities[7].

A similar assertion is made by Steven Shavell in an optimal deterrence theory which prescribes the legal rules that optimally deter socially harmful conduct and discusses the dilution of incentives arising from a wrongdoer's inability to pay for the losses it causes[8].

A gatekeeper may even be shielded from the full effects of a liability regime by insolvency, although it rarely occurs in practice (Arthur Anderson being a notable example). Some categories of gatekeepers may collaborate with each other to adopt risk-shifting arrangements; for example, 'comfort letters' exchanged among bankers, analysts, auditors, etc. Likewise, communications among regulators (such as between SEBI and RBI) may also be termed as risk-shifting or risk-sharing arrangements. The objective of such an exercise may be varied—allocating liability or getting additional knowledge of the clients' affairs or information exchange.

Corporate conduct is overseen by multiple gatekeepers who act on different aspects of business transactions. This ought to lead to an interlocking web of protection against

[5] AAA&S, Report of the American Academy of Corporate Responsibility Steering Committee
[6] 'The Devolution of the Legal Profession: A Demand Side Perspective', Ronald J.Gilson, 49 Md L.Rev., 869, 905 (1990)
[7] 'Multiple Gatekeepers', Andrew F.Tuch,Virginia Law Review, Vol.96, Issue 7, pp 1583-1672. Available at SSRN:http://ssrn.com/abstract=1577405
[8] 'Economic Analysis of Accident Law, Steven Shavell, 1st Harvard University Press paperback edition 2007, 1987, page 167-68.



wrongdoing by all gatekeepers, calling into question the conception of the gatekeeper as a unitary actor[9].

Gatekeepers operate in an interdependent rather than independent manner and it is important to have a certain degree of collective responsibility among all gatekeepers to harness the total capacity to deter wrongdoing. A regime of fault-based liability coupled with joint and several liability would be optimal for advancing the cause of optimal deterrence[10].

[9] 'Multiple Gatekeepers', Andrew F.Tuch, Discussion paper no.33, 3/2010, Harvard Law School, Cambridge, MA.

[10] Andrew Tuch, page 86

Reserve Bank of India

Traditionally, central banks have performed roles of currency authority, banker to the Government and banks, lender of last resort, supervisor of banks and exchange control (now it would be more appropriate to call it exchange management) authority. Generally, central banks in developed economies have price or financial stability as their prime objective and are often characterised by nearly complete autonomy. Milton Friedman[11] defines central bank relations with the government as one that is comparable to the relation between judiciary and the government.

Rolf Hasse[12] says that central bank independence relates to three areas in which the influence of government must be either excluded or drastically curtailed. These are:

a. Independence in personnel matters, that is, extent of influence of government in appointment procedures
b. Financial independence, that is, ability of government to finance government expenditure either directly or indirectly through central bank credits and
c. Policy independence , that is, extent of freedom in formulation and execution of monetary policy

Literature suggests that central bank independence reduces inflation variability or fluctuations over time because monetary policies will be allowed independent time horizons than that dictated by elected governments to satisfy other objectives. In other words, inflation and central bank independence are inversely related. As a corollary, high inflation over a sustained period will erode central bank independence when it breaches a threshold value of inflation after which public opposition will force politicians to step in and restrain the central bank[13]

However, this holds true largely for industrialised nations.

In developing countries the central bank plays a bigger role in the economy and cannot reasonably be expected to have a total hands-off approach or be totally independent of government; it has to nurture hand-hold and actively manage many aspects of the economy. To that extent a central bank in a developing country plays both a traditional and a non-traditional role that includes building independent institutions such as capital markets, sector regulators, watchdogs, etc. and plays both a regulatory and a development role.

Central banking functions in India are carried out by the Reserve Bank of India since independence by taking over the erstwhile Imperial Bank of India formed in 1935. RBI was originally set up to regulate the issue of currency, maintain foreign exchange reserves to enable monetary stability and generally to operate currency and credit system in the country. As the economy progressed, RBI's role underwent several shifts. For instance, when India followed a control model of economic governance, RBI's monetary policy was focussed on

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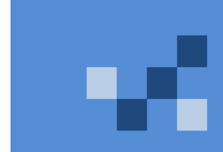
[11] 'Should There be an Independent Monetary Authority', In Search of a Monetary Constitution, Cambridge, mass., Harvard University Press, 1962
[12] 'The European Central Bank: Perspectives for Further Development of the Monetary System', Gutersloh, Bertelsman Foundation, 1990.
[13] A view propagated by Alex Cukierman, 'Central Bank Strategy, Credibility and Independence', Cambridge, Mass., MIT Press, 1992



allocating resources to various sectors and maintaining price stability. A novel mandate of RBI in its early stages was to finance five year plans, establishing specialised institutions to promote savings and to meet the credit needs of the priority sector.

The functions of RBI have undergone a strategic shift post liberalisation in the 1990s and are now more in the nature of facilitation of efficient functioning of money and capital markets besides strengthening of supporting institutional infrastructure. The leitmotif of change in RBI's interventions is to move from control to facilitation in all aspects—foreign exchange reserves, fixing interest rates, providing an operating framework for banks and setting down disclosure and transparency parameters.

RBI has been largely successful in its objectives of growth with stability, developing India's banking and financial sector and ensuring evolution of competitive markets. Inevitably, because of the liberalisation process, Indian banking sector is subject to greater shocks from external sources; for instance, a market-based exchange rate system has integrated the Indian economy into the global economy but the exchange rate has become more volatile. To that extent there is a partial loss of autonomy of domestic monetary policy.

The broad mandate of RBI currently is:

- Stimulate economic growth by controlling monetary expansion (or contraction) including making adjustments to the interest rate structure
- Maintain internal price stability by monitoring inflationary pressures
- Developing the banking and financial sector and to maintain a proper oversight and regulatory role.

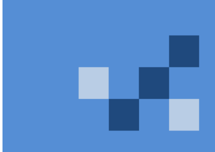
The RBI indirectly also controls the commercial sector by regulating the lending policy of banks and financial institutions and maintains an indirect oversight role over businesses through mandatory information submission.

Total Market capitalization of the banking sector in India is Rs 6,89,751 crores as on March 31, 2011[14].

The total flow of financial resources to the commercial sector from banks was Rs 7,11,031 crores as on March 31, 2011[15].

The model of governance of banks and financial institutions followed by RBI is through prescribing prudential norms and laying down broad disclosure principles coupled with periodic surveillance rather than direct interference and micro-managing the banking section of the economy but at the same time retaining the ultimate objective of strengthening market institutions to infuse greater transparency and liquidity in financial markets.

[14] Annual Report of SEBI for the year ending March 31, 2011
[15] Annual Report, RBI for the year ending March 31,2011

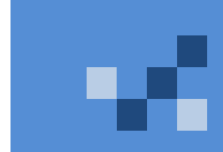


1. The Main Functions of RBI

- To act as regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- To formulate, implement and monitor the monetary policy.
- To ensure adequate flow of credit to productive and priority sector.
- To protect the interests of bank customers and public at large.
- To control the monetary supply by issuing currency and regulating minimum margins for various advances received by Banks (Cash Reserve Ratio, Statutory Liquidity Ratio)
- To act as banker for the entire financial sector by lending/ accepting deposits at the bank rate of interest.
- To act as controller of credit i.e. it has the power to influence the volume of credit created by banks in India by changing the Bank rate or through open market operations. It can impose both quantitative and qualitative restrictions.
- To monitor economic indicators and structure of the country for price stabilisation and economic development.
- To control the banking system through the system of licensing, inspection and calling for information.
- To facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

RBI's ambit of *supervisory and regulatory* powers covers following:

- Regional Rural Banks
- Public sector banks
- Private Banks
- Foreign banks
- Cooperative Banks
- Non-Banking Finance Companies



- Institutions formed under special Acts (State Bank of India Act, The Industrial Development Bank Act, The Industrial Finance Corporation, National Bank for Agriculture and Rural Development Act, National Housing Bank Act, Deposit Insurance and Credit Guarantee Corporation Act
- Small Industries Development Bank of India.

RBI's power of supervision and control over commercial and co-operative banks relates to licensing, branch expansion, asset liquidity, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorized to carry out periodical inspections of banks and to seek returns and necessary information.

The Reserve Bank of India has the responsibility of maintaining the official rate of *foreign exchange* and acts as the custodian of India's reserve of international currencies.

RBI is mandated to promote the habit of banking, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, RBI has helped in setting up of Industrial Finance Corporation of India, Sate Finance Corporation, Deposit Insurance Corporation, Unit Trust of India, Industrial Development Bank of India, Agricultural Refinance Corporation of India and Industrial Reconstruction Corporation of India.

2. RBI & Corporate Governance

Banks play a pivotal role in the financial and economic system of any country. RBI plays a leading role in formulating and implementing corporate governance norms for India's banking sector.

The ambit encompasses safeguarding and maximizing the shareholders' value, upholding retail depositors' risk and stabilizing the financial system so as to conserve the larger interests of the public. This role becomes important in view of the fact that in India bank assets often lack transparency and liquidity because most bank loans, unlike other products and services, are customized and privately negotiated. Banks are 'special' as they not only accept and deploy large amount of uncollateralized public funds in a fiduciary capacity, but they also leverage such funds through credit creation. They are also important for smooth functioning of the payment system[16].

[16] 'A comprehensive policy framework for ownership and governance in private sector banks', RBI circular dated July 2, 2004

In case of instability of one bank owing to incompetent or unethical management, the entire financial system and the economy may be impacted adversely. As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, leading to early liquidation and exposing the entire financial system to chaos. In such a situation, the interest of borrowers (corporates, retail, etc.) may also be affected in terms of availability of credit, recall of credit lines and loss in valuation of mortgaged assets.

Two main features set banks apart from other business – the level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities. The opaqueness in banking creates considerable information asymmetries between the "insiders" – management – and "outsiders" – owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of banks as well as siphon off funds[17].

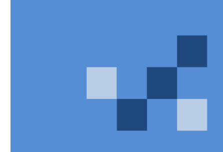
The Reserve Bank of India performs corporate governance function under the guidance of the Board for Financial Supervision (BFS). Primary objective of BFS is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies.

BFS was constituted in November 1994 as a committee of the Central Board of Directors of the Reserve Bank of India. The Board comprises of four directors of RBI from Central board and is chaired by Governor. The Board is required to meet normally once every month. It considers inspection reports and other supervisory issues placed before it by the supervisory departments.

The BFS oversees the functioning of Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS) and Financial Institutions Division (FID) and gives directions on the regulatory and supervisory issues.

BFS inspects and monitors banks using the "CAMELS" (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. BFS through the Audit Sub-Committee also aims at upgrading the quality of the statutory audit and internal audit functions in banks and financial institutions.

[17] 'Corporate Governance in India – Evolution and Challenges' Rajesh Chakrabarti



2.1 Corporate Governance mechanism followed by RBI

Corporate Governance mechanism followed by RBI follows are a three-pronged approach:

a) Disclosure and Transparency

b) Off-site surveillance

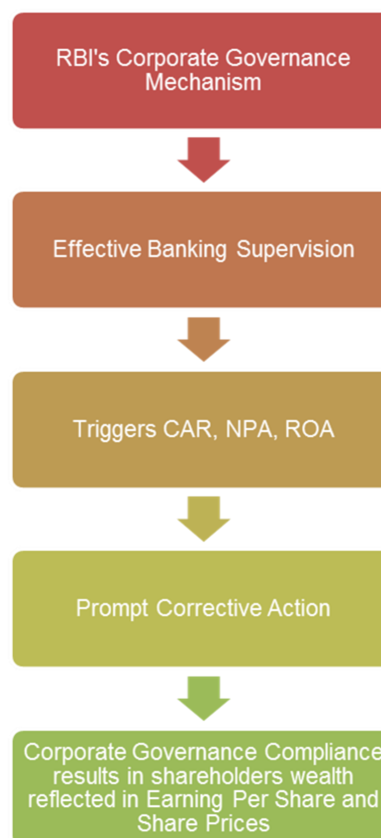
c) Prompt corrective action

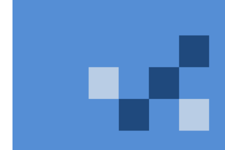
a) **Disclosure and transparency** are the main pillars of a corporate governance framework enabling adequate information flow to various stakeholders and leading to informed decisions. Accounting standards in India in all sectors including banking sector have been enhanced to align with international best practices.

b) The **off-site surveillance mechanism** monitors the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI promotes self- regulation and market discipline among the banking sector participants and has issued prudential norms for income recognition, asset classification, and capital adequacy. RBI brings out periodic data on 'Peer Group Comparison' on critical ratios to maintain peer pressure on individual banks for better performance and governance.

c) **Prompt Corrective Action** is a supervisory mechanism implemented as part of Effective Banking Supervision in terms of Basel II requirements. It is based on a pre-determined rule based structure of early intervention whereby benchmark ratios for three parameters—Capital Adequacy Ratio, Non-Performing Assets Ratio and Return on Assets—are determined. Any breach of these trigger points is considered as early warning on the financial health of the banks and appropriate mandatory or discretionary action is initiated by the RBI.

RBI's Corporate Governance Mechanism





'Published balance sheet, off-site returns and on-site inspection report (are) the primary sources for identifying the banks which could be placed under the PCA framework. The 1980s and early 1990s were a period of great stress and turmoil for banks and financial institutions all over the globe. These events led to the search for appropriate supervisory strategies to avoid bank failures as they can have a destabilizing effect on the economy.

For this reason, medium or large banks are rarely closed and the governments try to keep them afloat. In both industrial and emerging market economies, bank rescues and mergers are more common than outright closure of the banks. If banks are not to be allowed to fail, it is essential that corrective action is taken well in time when the bank still has adequate cushion of capital so as to minimize the cost to the insurance fund / public exchequer in the event of a forced liquidation of the bank'[18].

Thus triggers based on CAR, Net NPAs and ROA are linked to a bank's performance in three critical areas which are quantifiable and which form an integral part of the supervisory oversight. The actions are designed to pre-empt any deterioration in the soundness of banks.

RBI considers Capital Adequacy norms, Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability and undertakes effective banking supervision and timely intervention through these early warning signals. Breach of these trigger points invites disciplinary action from RBI, both mandatory and discretionary; some of these actions are listed in Annexure I.

2.2 Other Corporate Governance Mechanisms

a. Apart from working under the jurisdiction of RBI as mentioned above, listed banks, Non-Banking Finance Companies and other financial intermediaries are governed by SEBI' s clause 49 on corporate governance (as discussed in a section on SEBI).
b. Additionally, RBI has also issued various circulars and notifications that provide guidelines on:
    - Composition, Qualification, Independence and Remuneration of Board of Directors.
    - Roles, Responsibilities and Training of Executive Directors.
    - Resolution of Conflict of Interest in case of related party transactions.

[18] RBI circular on Prompt Corrective Action dated March 30, 2001

- Constitution of Nomination Committee, Risk Management Committee and Audit Committee

c. Audit of Banks:

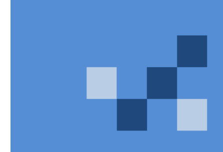
One of the inspection and monitoring tools used by BFS is the quality of audit (both statutory and internal) conducted on the banking sector. Although public sector banks have the operational freedom in the matter of appointment of auditors, they need to choose from a list prepared by the Comptroller and Auditor General of India (CAG) and the Institute of Chartered Accountants of India (ICAI) and such names must be approved by the Reserve Bank of India (RBI) before banks can select statutory auditors. Banks are required to allot the top 20 branches (to be selected strictly in accordance with the level of outstanding advances) in a manner as to cover a minimum of 15% of total gross advances of the bank by the statutory auditors. Banks do not have the authority to remove audit firms during their working tenure without the prior approval of RBI.

Influence on the corporate sector

RBI as regulator of the banking sector has an immense bearing on the corporate sector (and the entire economy) in terms of rates of interest, foreign exchange, anti-money laundering etc. as summarised in the table:

	Policy	**Impact**
1.	Monetary Policy- determines the Repo Rate, Bank Rate, Cash Reserve Ratio, Statutory Liquidity Ratio.(Changes in the prime interest rate)	It determines the cost of borrowing of the corporate sector affecting the profitability, capital budgeting decisions, creation of production capacities depending upon the credit availability etc. Past events in the world have shown that easy liquidity has propelled the economies out of recessionary business cycles and led them to higher growth trajectory.
2.	Monetary Policy- (cont.) (Changes in the money available in circulation, reserve requirements of banks)	It controls the inflationary pressures both on capital assets and price of consumable goods. Currently RBI's rate increase to cool off inflation has adversely impacted business plans by reducing disposable income in the hands of industrial and consumer users.
3.	Interventions in Foreign Exchange Market- (By buying or selling the foreign currency to ease out volatility in forex market)	It reduces the currency risk involved in making payment of imports, repayment of loan and interest thereon. It makes exports competitive by bringing certainty in receivable collection and product/ services pricing in international markets. It also enables borrowing in foreign currency through External Commercial Borrowings,

		Foreign Currency Convertible Bonds etc. by facilitating a stable investment portfolio for international investors.
4.	Export/ Import Regulations (Foreign Exchange Management Act Guidelines)	Export proceeds should be realised within 12 months of the date of the export which encourages time bound collections. Payment of imports under automatic route or by way of advances in case of certain specific items is governed by RBI.
5.	Regulation of investment in Indian Companies by Foreign Institutional Investors, Non Resident Indians, Persons of Indian Origin via portfolio investment scheme. (Acquisition of shares and debentures in Indian Companies through stock exchanges)	RBI has imposed sectoral cap and statutory ceiling for corporates. These approvals determine investible funds with Indian corporate sector.
6.	Guidelines for Indian direct investment in joint ventures and wholly owned subsidiaries abroad.	It affects business strategic expansion decisions, foreign technology sourcing, and resource (labour / material) availability and export market development.
7.	External Commercial Borrowings (ECB) (Bank Loan, Buyers' credit, Suppliers credit, securitised instruments, etc. from sources outside India)	RBI approval mandatorily required subject to certain limits under automatic route. The borrower must obtain a Loan Registration Number (LRN) from the Reserve Bank of India before drawing down the ECB.
8.	Foreign Currency Convertible Bonds Issuance Guidelines. (FCCBs)	FCCBs can be issued up to $500 million under automatic approval route. For amounts greater than $500 million, RBI approval required. It impacts the debt equity ratios of companies.
9.	Anti-Money Laundering, Know Your Client Norms	Corporates (as well as individuals and other entities) have to fulfil Bank Account Opening norms as to mandated documentation, adherence to anti money laundering norms on prohibited cash deposits in bank deposits.
10.	Priority sector lending norms require Indian banks and foreign banks to lend 40% and 32% of net bank credit respectively to priority sector.	It helps the corporates involved in following areas to avail of credit facility at lower rate of interest. Agriculture sector, Small Scale Industries, Small road and water transporters, Small businesses, Retail Trade, Professionals and Self Employed, Persons, Education sector, Housing sector, Micro Credit organizations, Food and agro processing sector. It also enhances the investment activity in the economy.



3. Effectiveness of Reserve Bank of India as a Regulator of the Banking Sector

RBI regards Capital Adequacy Ratio (CAR), Non-Performing Assets (NPA) and Return on Assets (ROA) as proxies for asset quality and profitability and measure of corporate governance mechanism supervision.

Extending the reasoning to input the share price and earning per share (EPS) of the Banks as reflection of best corporate governance practices, a correlation has been drawn among the above ratios (CAR, NPA and ROA) and Share Price and EPS on individual ratio basis.

Objectives- The study seeks to achieve two objectives:

(i) Whether the banks have been able to maintain the above ratios within the trigger.

(ii) Whether the movements (favourable/otherwise) gets reflected in the share prices and earning per share of the banks, assuming other variables determining market price and earnings are constant.

Methodology-

Following data was collected for 15 listed banks (public- 10 and private-5) for a period of 5 years beginning March 31, 2006 and ending March 31, 2010. **The sample size of the study represents 70% of the total capital and reserves of the public sector banks and private sector banks in India**.

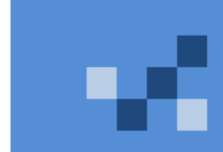
Ratios used:

a) Capital Adequacy Ratio (CAR) is used as a measure to check on the availability of the bank's capital to cover for its risk weighted assets.

$$\text{CAR} = \frac{\text{Tier One Capital + Tier Two Capital}}{\text{Risk Weighted Assets}}$$

Banks are required to maintain capital adequacy ratio at 9%.

Banks with a higher risk assets profile are required to maintain a higher level of capital funds. Alternatively, banks which have less capital will be required to reduce those assets which carry higher risk weight.



b) **Non-Performing Assets (NPA) Ratio** is used as a measure of the overall quality of the bank's loan book.

$$\text{NPA Ratio} = \frac{\text{Gross NPA*- Total Accumulated Provisions}}{\text{Total Advances}}$$

***(Assets having interest overdue for more than 90 days)**

Banks are required to maintain NPA ratio at 10%.

Higher ratio reflects rising bad quality of loans.

c) **Return on Asset** (ROA) is used a measure of profitability and earning capacity of assets.

$$\text{ROA Ratio} = \frac{\text{Net Profits}}{\text{Total Assets (including Fixed Assets)}}$$

***(Assets having interest overdue for more than 90 days)**

Banks are required to maintain ROA ratio at 0.25%. The higher the proportion of average earnings assets, the better would be the resulting returns on total assets.

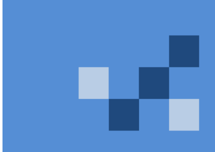
The figures for these ratios have been taken from RBI's Statistical Tables.

As per RBI's Annual report for the year ended March 31, 2011 the ratios (2009-2010) for the Indian Banking Sector are as under:

Ratio	Percentage
Capital Adequacy Ratio	13.6
Non-Performing Asset	2.4 (Gross)
Return on Assets	1.05

d) **Share Prices (taken as a proxy for corporate governance)**[19]
e) **Earnings Per Share (taken as a proxy for corporate governance)**[20]

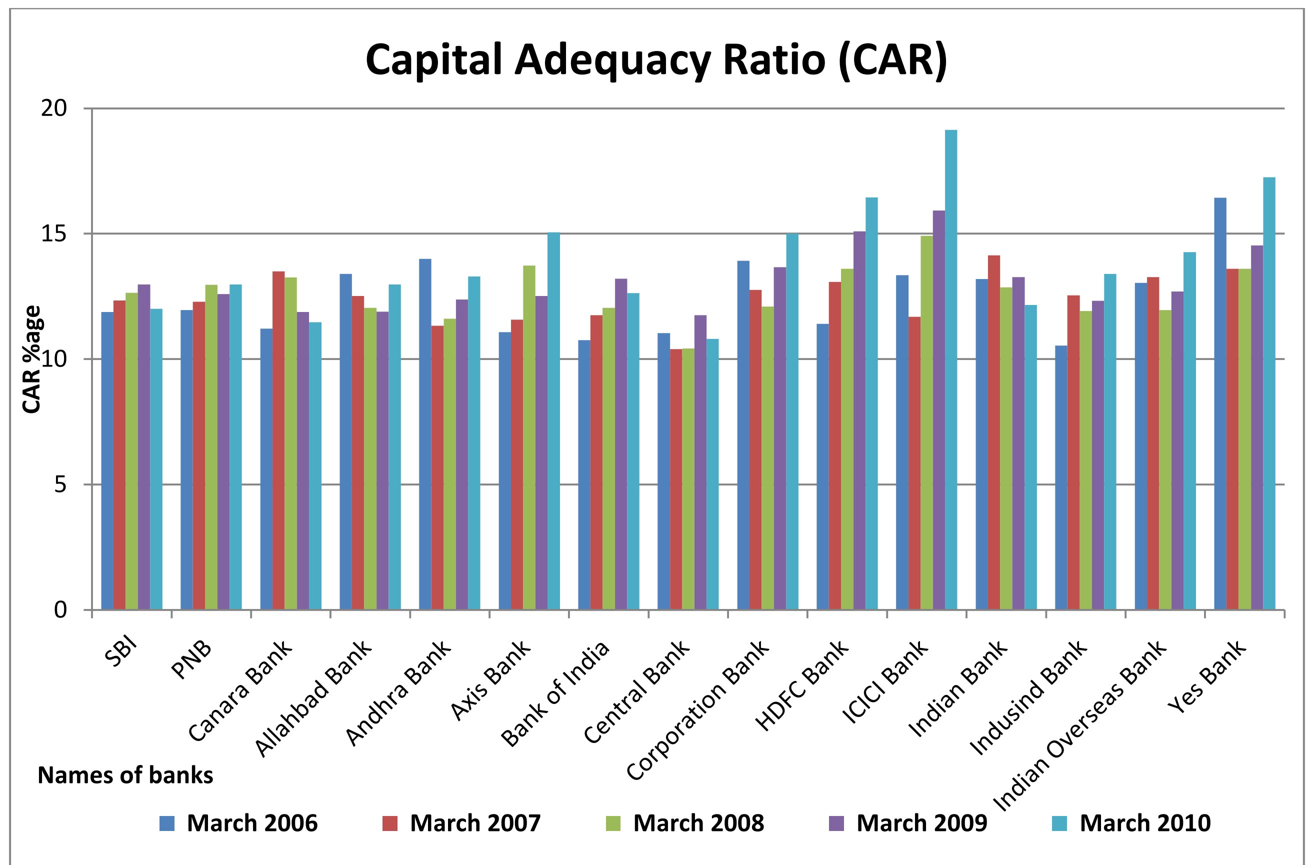
[19] Source: www.bseindia.com
[20] Source: www.rediff.money.com) and company's

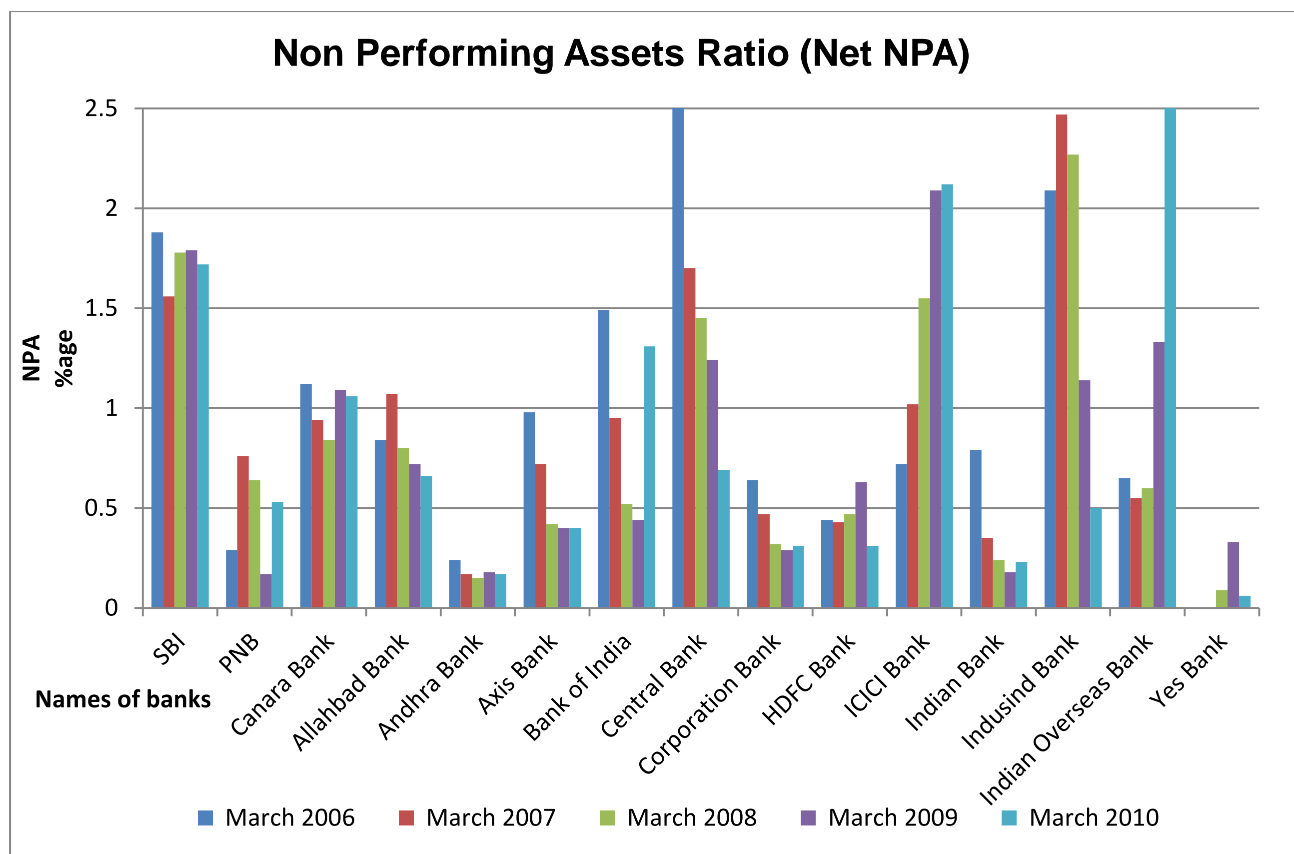


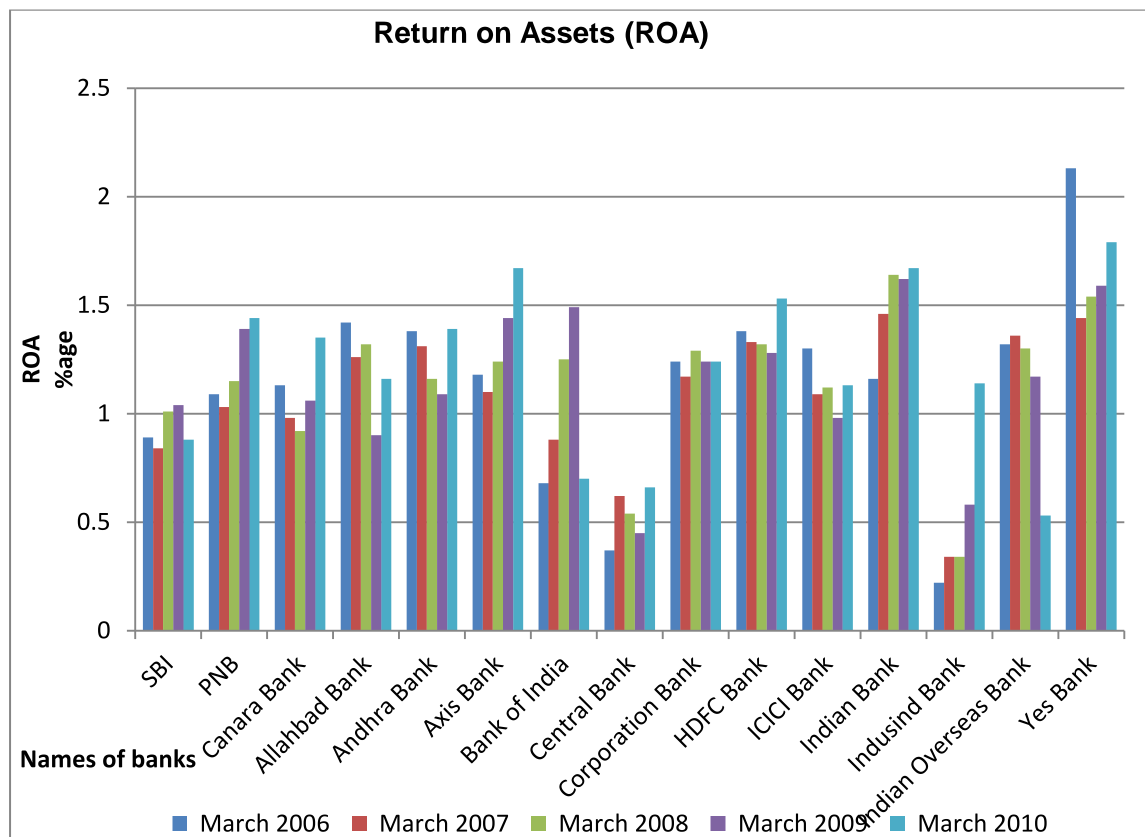
Annual Reports

Preliminary Data Analysis

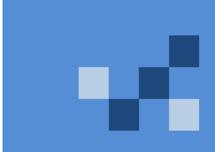
(i) All banks were able to follow the trigger limits (CAR: 9%, NPA: 10% and ROA: 0.25% during the sample period.

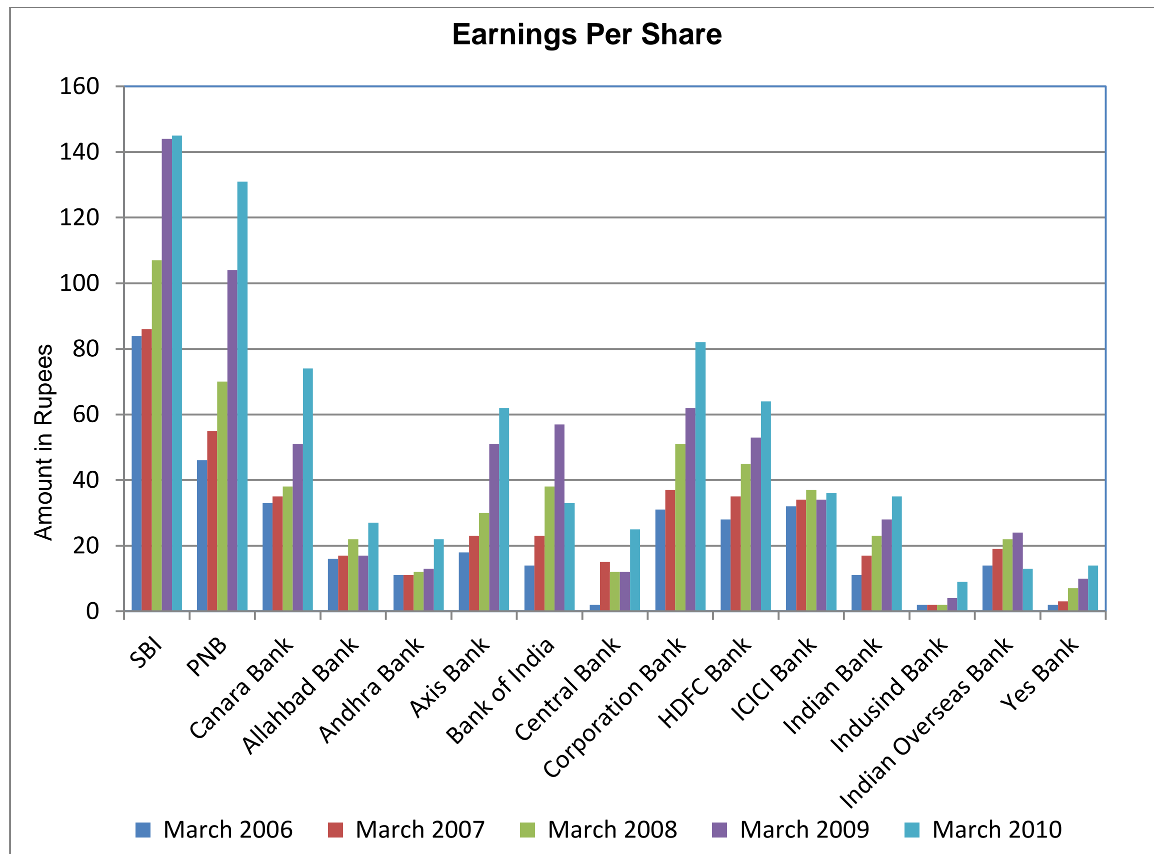


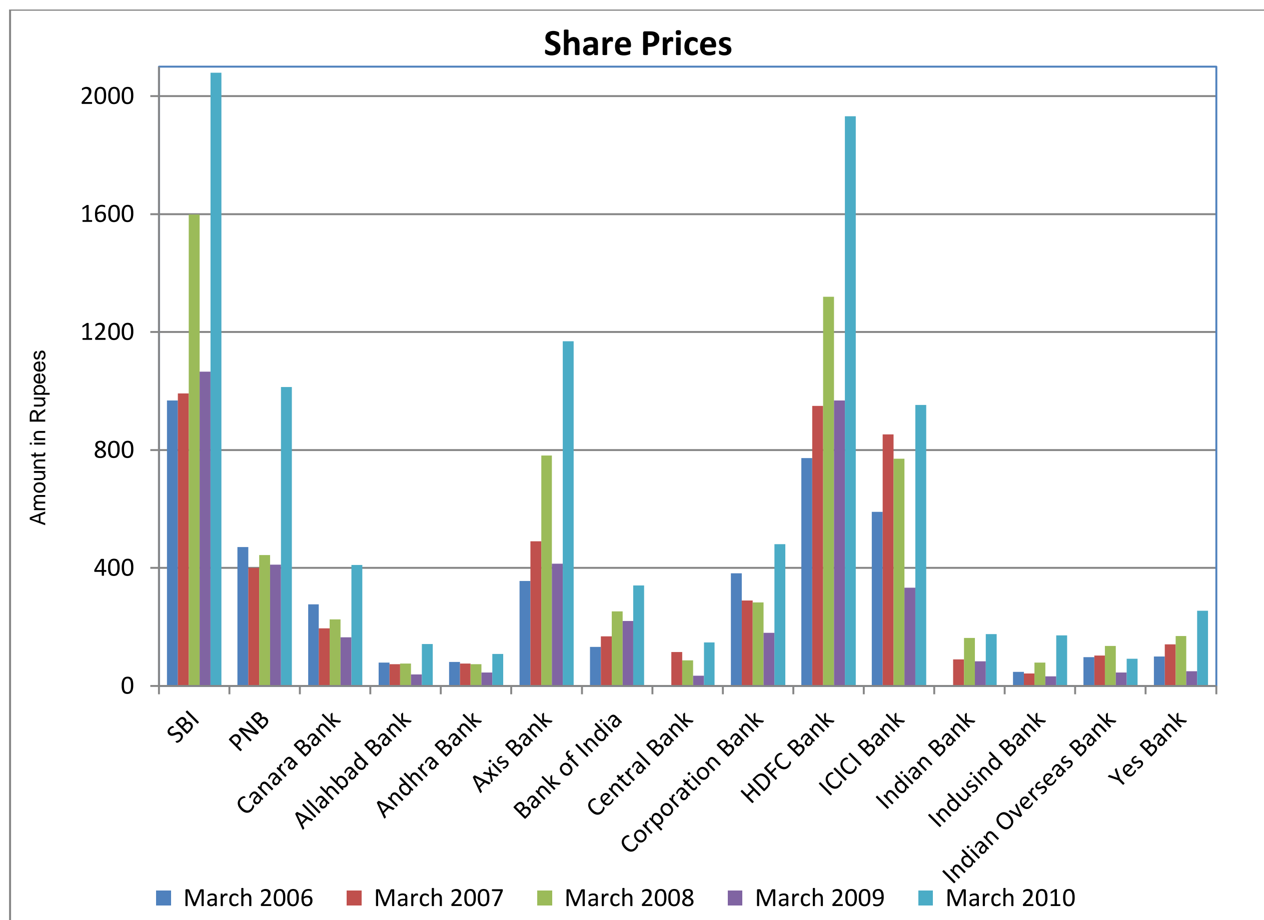




(ii) Earning Per Share and the Share Prices have been taken as proxies for corporate governance.




Earnings Per Share
Amount in Rupees
0
20
40
60
80
100
120
140
160
SBI
PNB
Canara Bank
Allahbad Bank
Andhra Bank
Axis Bank
Bank of India
Central Bank
Corporation Bank
HDFC Bank
ICICI Bank
Indian Bank
Indusind Bank
Indian Overseas Bank
Yes Bank
March 2006
March 2007
March 2008
March 2009
March 2010


Share Prices
Amount in Rupees
0
400
800
1200
1600
2000
SBI
PNB
Canara Bank
Allahbad Bank
Andhra Bank
Axis Bank
Bank of India
Central Bank
Corporation Bank
HDFC Bank
ICICI Bank
Indian Bank
Indusind Bank
Indian Overseas Bank
Yes Bank
March 2006
March 2007
March 2008
March 2009
March 2010

(iii) We have linked the ratios (CAR, NPA and ROA) with share price and EPS. The results are summarized in the following table.

Particulars	SBI	PNB	Canara Bank	Allahbad Bank	Andhra Bank	Axis Bank	Bank of India	Central Bank	Corporation Bank	HDFC Bank	ICICI Bank	Indian Bank	Indusind Bank	Indian Overseas Bank	Yes Bank
Corelation %age CAR & Share Price	-19.98%	50.39%	-53.46%	58.16%	38.47%	94.36%	66.35%	-68.81%	63.14%	79.50%	13.78%	-84.04%	60.13%	-25.79%	38.90%
Corelation %age NPA & Share Price	-3.28%	8.71%	27.21%	-31.91%	1.04%	-60.49%	-11.99%	-34.25%	24.33%	-62.53%	-7.14%	-18.88%	-65.47%	-37.76%	-51.45%
Corelation %age ROA & Share Price	-0.10%	64.69%	86.56%	29.02%	84.52%	70.89%	5.50%	99.24%	1.95%	76.77%	26.25%	67.44%	84.18%	19.76%	-2.16%
Corelation %age CAR & EPS	37.37%	72.26%	-44.99%	5.73%	35.01%	78.28%	91.56%	-21.19%	55.23%	98.59%	51.63%	-66.18%	72.05%	-75.47%	38.18%
Corelation %age NPA & EPS	10.29%	-20.21%	31.32%	-57.75%	-26.36%	-78.76%	-81.29%	-91.57%	-80.77%	-12.98%	60.32%	-81.19%	-92.87%	-40.28%	48.43%
Corelation %age ROA & EPS	46.86%	96.32%	80.79%	-5.09%	36.11%	96.43%	87.23%	79.19%	28.99%	45.92%	-39.25%	84.03%	98.99%	50.54%	-14.88%
Corelation %age EPS & Share Price	57.91%	74.74%	68.58%	82.77%	66.26%	65.12%	44.74%	81.71%	28.26%	83.01%	49.13%	52.36%	85.93%	-19.85%	47.55%
Corelation %age CAR & Share Price (without	5.87%	54.23%	-76.64%	32.31%	53.45%	98.55%	92.51%	86.36%	97.84%	97.62%	54.23%	-97.69%	70.95%	-90.03%	36.48%

Conclusions of data analysis:

Summary of the correlation run over 15 banks for a period of 5 years has been tabulated as under.

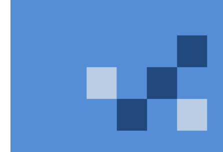
Particulars	Expected Correlation	Actual Positive	Actual Negative	Conclusion	Hypothesis Proved/ Not
Correlation %age CAR & Share Price (entire duration of sample)	Positive	10	5	Results impacted by global meltdown following collapse of Lehman Brothers reflected in fall of share prices in March 2009	No
Correlation %age CAR & Share Price (without 2009)	Positive	11	4	Percentages calculated for 4 years after removing numbers for 2009. Banks attempt to reduce high risk assets results in better share prices	Yes

Correlation %age NPA & Share Price	Negative	4	11	An overall attempt to increase asset quality gets reflected in the earnings and higher share prices	Yes
Correlation %age ROA & Share Price	Positive	12	3	Any improvement in productivity of assets is awarded by the share markets	Yes
Correlation %age CAR & EPS	Positive	11	4	Efforts to reduce the risk profile of assets induces enhanced shareholders earnings	Yes
Correlation %age NPA & EPS	Negative	3	12	Declining non-performing assets improves the critical performance area of the banking sector and profitability.	Yes
Correlation %age ROA & EPS	Positive	13	2*(correlation Coefficient less than 2%)	Improving allocation of funds to profitable assets results in higher returns	Yes
Correlation %age EPS & Share Price	Positive	14	1	Equity Markets are reflection of the present earnings of the companies	Yes

1. Correlation between CAR and Share Prices of 15 banks over a period of 5 years gives the following results.

- Cases of Positive Correlation between CAR and Share Price-10
- Cases of Negative Correlation between CAR and Share Price-5

However it may be noted that there was a steep fall in the bank share prices after sub prime crisis post September 2008. Hence closing prices of March 31, 2009 show an extreme downward trend.



In order to mitigate the above impact of extraordinary nature, we conducted a correlation analysis for 4 years without the numbers for 2009.

- Cases of Positive Correlation between CAR and Share Price-11
- Cases of Negative Correlation between CAR and Share Price-4

The results showed that CAR and share prices are positively correlated in 11 out of 15 cases.

The study finds that in most of the cases, an improvement in CAR results in better asset quality, higher returns and share prices.

2. Correlation between NPA ratio and Share Prices of 15 banks over a period of 5 years gives the following results.

- Cases of Positive Correlation between NPA and Share Price-4
- Cases of Negative Correlation between NPA and Share Price-11

In most of the cases, any increase in the NPA ratio shows deteriorating asset quality and a consequent fall in share prices.

3. Correlation between ROA and Share Prices of 15 banks over a period of 5 years gives the following results.

- Cases of Positive Correlation between ROA and Share Price-12
- Cases of Negative Correlation between ROA and Share Price-3

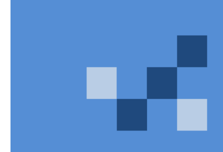
In most of the cases, any improvement in ROA results in increase in overall shareholders wealth reflected in higher share prices.

4. Correlation between CAR and EPS of 15 banks over a period of 5 years gives the following results.

- Cases of Positive Correlation between CAR and EPS-11
- Cases of Negative Correlation between CAR and EPS-4

In most of the cases, any improvement in CAR is reflected in increased profitability and actual wealth increase of shareholders.

5. Correlation between NPA and EPS of 15 banks over a period of 5 years gives the following results.



- Cases of Positive Correlation between NPA and EPS—3
- Cases of Negative Correlation between NPA and EPS—12

In most of the cases, any reduction in NPA leads to higher profitability and better EPS.

6. Correlation between ROA and EPS of 15 banks over a period of 5 years gives the following results.

- Cases of Positive Correlation between ROA and EPS—13
- Cases of Negative Correlation between ROA and EPS—2*

  (*In these two cases correlation coefficient was less than 2%)

In most of the cases, any improvement in ROA translates into greater returns on capital and enhanced EPS.

7. Finally the EPS of the banks have been correlated to the share prices.

- Cases of Positive Correlation between ROA and EPS- 14
- Cases of Negative Correlation between ROA and EPS- 1*
  (*Substantial share fall in March 2009 in case of one bank)

In almost all the cases they move together in positive tandem.

Limitations:

The above study is subject to limitation of possible manipulation of year end numbers (if any) that may be carried out to improve ratios.

CAR may be influenced by revaluation of assets, converting assets into off balance sheet items through Special Purpose Vehicles and reducing the risk weightage or transfer of risky assets within the same banking group, as some examples.

NPA ratios also depict the aggressiveness and risk appetite of banks. Higher risk may lead to higher returns in initial phases but the portfolio may be tarnished with delinquencies and provisions at later stages. Sticky loans may be rescheduled on the basis of early warnings of repayments and may not reach the bucket of greater than 90 days, necessitating provisions.

ROA Ratio may be re-worked to give higher returns by reducing the asset value at the year-end via securitisation, inter group transfers etc.

Subject to these limitations, the study concludes that prompt corrective action prescribed by RBI in situations where norms are not followed has helped to maintain the financial health of the Indian banking sector.

Therefore, it is reasonable to conclude that Reserve Bank of India, through its policies, has insulated the Indian economy from the effects of one of the worst global crisis following the fall of Lehman Brothers in October 2008 and from the impact of sub-prime crisis due to limited exposure to toxic assets owing to the counter-cyclical prudential norms prescribed by the Reserve Bank.

However, this insulation was more a result of habitual conservatism of RBI in terms of laying down strict guidelines of products that are offered by banks than as a conscious decision to avoid potentially dangerous products. There are several instances where the cost of RBI's conservatism has been borne by Indian consumers in terms of high cost of borrowings. Another aspect of the restrictive product policies in terms of derivatives, credit swaps, and securitization is the high cost of funds to the banks which ultimately gets transferred on to the regular consumer.

For instance, Credit Default Swaps are not allowed in India; these instruments help transfer the risk of credit default on an underlying credit from the lender to another market intermediary. They also help promote market liquidity, risk shifting, and accurate pricing of credit risk and finally to reduced cost of borrowings. The risks involved in such type of instruments is also very high, as the world witnessed, but to absolutely ban all risky instruments may not be the best solution for an economy.

In October 2011 the reputed credit rating agency Moody downgraded State Bank of India, India's largest public sector bank in India (to "D") on account of low Tier I capital ratio and deteriorating asset quality. This suggests modest intrinsic financial strength, potentially requiring some outside support at times. (Similar rating for SBI's private sector peers, like ICICI Bank, HDFC Bank and Axis Bank is at "C".)

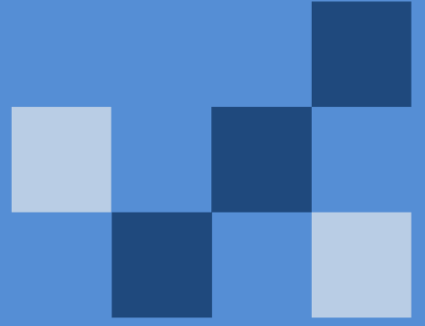
The rating downgrade not only puts pressure on the government to induce fresh capital but also questions the promptness of RBI's current asset quality supervisory mechanism. SBI's Gross Non Performing Assets have increased by 30% from Rs 19,535 crores in March 2010 to Rs 25,326 crores in March 2011 and the capital adequacy ratio on Basel II norms has fallen from 13.39% in March 2010 to 11.98% in March 2011.

State Bank of India	March 2006	March 2007	March 2008	March 2009	March 2010	March 2011
Net Non-Performing Asset Ratio	1.88	1.56	1.78	1.79	1.72	1.63
Gross Non Performing Asset Ratio	3.61	2.92	3.04	2.86	3.05	3.28

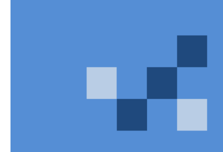
The explanations for above SBI's failure is beyond the scope of this paper but it is reasonable to conclude that such slips in asset quality of SBI over the past 3 years should have been more proactively inspected and dealt with by RBI, finance ministry and government of India without giving an opportunity to a foreign credit rating agency ring the alarm bell.

Conclusion: All these indicators suggest that the monitoring and oversight mechanism instituted by Reserve Bank of India towards improving corporate governance of banks and by inference, of individual borrowers is robust and effective. The mechanisms also promote efficient management of the banking sector in general and are rewarded by the capital market through increase in shareholders' equity. Thus, Reserve Bank of India is effective as a regulator of the banking sector and a good gatekeeper of corporate governance.

This working paper restricts itself to the study of RBI's effectiveness in regulating the banking sector. There are several instances where RBI seeks information directly from the commercial sector and can therefore enforce checks and balances to instill good corporate governance. RBI's effectiveness as a gatekeeper of the corporate world directly is not covered here and is the subject of further research.



ANNEXURE



Annexure I – RBI

Actions Taken by RBI in case of Breach of Trigger Points

In case of breach of the stipulated ratios following actions (mandatory/ discretionary) depending upon the level of breach may be taken.

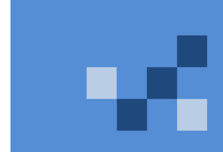
a)Capital Adequacy Ratios less than 9%

Mandatory

- Submission and implementation of capital restoration plan
- Restriction on expansion of risk-weighted assets
- Restriction on entry into new lines of business
- Paying off costly deposits and CDs
- Reduction / suspension of dividend payments
- Discussion with the bank's Board on corrective plan of action
- Ordering of recapitalisation
- Reduction in stake in subsidiaries
- Revision of credit / investment strategy and controls
- Reduction in advances / capital expenditure / overheads

Discretionary Actions

- Shedding of risky business
- Restrictions on borrowings from inter bank market
- Bringing in new Management / Board
- Appointment of consultants for business / organisational restructuring
- Change of promoters / change in ownership
- Merger if the bank fails to submit / implement recapitalisation plan or fails to recapitalise pursuant to order, within such period as RBI may stipulate.



b) Non Performing Assets Ratio less than 10%

Mandatory Actions

- Special drive to reduce the stock of NPAs and contain generation of fresh NPAs
- Review of loan policy
- Upgrading credit appraisal skills and systems
- Strengthening of follow-up of advances including loan review mechanism for large loans
- Effective follow-up of suit filed / decreed debts
- Putting in place proper credit-risk management polices / process / procedures / prudential limits
- Reduction of loan concentration - individual, group, sector, industry, etc.

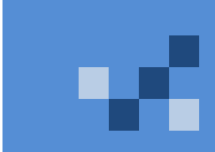
Discretionary Actions

- Restriction on entry into new lines of business.
- Reduction / suspension of dividend payments
- Reduction in stake in subsidiaries

c) Return on Assets less than 0.25%

Mandatory Actions

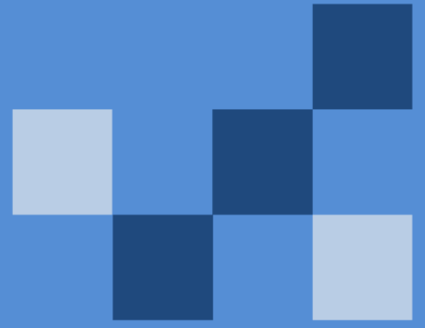
2. Paying off costly deposits and CDs
3. Increasing fee based income
4. Containing administrative expenses
5. Special drive to reduce the stock of NPAs and contain generation of fresh NPAs
6. Restriction on entry into new lines of business
7. Reduction / suspension of dividend payments
8. Restrictions on borrowings from inter-bank market



Discretionary Actions

- Capital expenditure only for technological up-gradation and for day-to-day operations within Board approved limits
- Staff expansion / filling up of vacancies only with prior approval of RBI, except recruitment of specialists

If a bank's performance under any of the three broad parameters has crossed the trigger points, the bank will be placed under corrective action programme. Such corrective action will consist specific mandatory action and those of discretionary actions, which in the opinion of Reserve Bank, may be applied to the concerned bank.



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