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**“Impacts of Global Financial Crisis on the
Corporate Governance Practices in Indian Banks:
Implications and policy resolutions”**



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Abstract

The present paper deals with various issues of corporate governance relating to its concept and describes various committee issues of corporate governance in the Indian economy and relates it with Indian banking systems. We are passing through a turbulent phase in the global economy, the spill-off of which is being witnessed in India as well, while India can never be fully insulated from global happenings. The economic crisis, which originated in the financial sector of the United States, is being transmitted to the countries around the world. Corporate Governance as practiced in India has as its primary goal i.e., optimization of the performance of corporate entities within the limitations placed on the corporate work environment by the intensity of investor aspirations on one hand and the compulsions of public interest and situational constraints on the other. Banking is clearly a special sub-set of corporate governance with much of its management obligations enshrined in law or regulatory codes. Indian banking sector plays a catalytic role because of the critical nature of the relationship with business or corporate sector and large public ownership. This paper develops a model of the causes and consequences of corporate governance practices in Indian banks.

Key words: Corporate governance, jeopardizing, aspirations, turbulent, adherence.

Introduction:

“The crisis has caused a massive breakdown of trust in the financial system, bankers, business, business leaders, investment advisers, credit rating agencies, politicians, media and in the process of globalisation.”

Duvvuri Subba Rao

Governor, Reserve Bank of India

Globalization has been one of the major events in the world economy in the last two decades. It compressed the world, intensified the consciousness of the world as a whole and deepened the worldwide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away and vice versa. During the past two decades the business cycles in the large emerging Asian economies and in the developed economies have been quite different. Many transnational companies use emerging markets as a part of their production chains and this is especially true for the Asian economies. China and India played only a marginal role in the world economy before the 1990s. Whereas China was a predominantly agrarian economy before 1980. More recently, India has joined this pattern of economic development.

Banking and financial crises have been a common phenomenon throughout the modern economic history of mankind. Although the global financial crisis have not spared India, Indian banks still appear to be unaffected by the slowdown. Globalization and liberalization, undoubtedly, brought benefits of advancement, but globalization and liberalization, especially in the financial sector, were also responsible for increasing instability. The international financial crisis that erupted in the US has started spreading ripples of troubles worldwide. The world saw the abject failure of the US Government to find a solution. The solution must be consistent with justice and social solidarity for all countries, reflect an understanding of the necessary balance between Government and markets, more global cooperation in setting macroeconomic policies, rebuilding trust in the financial markets and respect the principles of

democratic due process, including full transparency. Globalisation will not only significantly heighten business risks, but will also compel Indian companies to adopt international norms of transparency and good governance. The real factor behind the financial crisis is the macro-economic profligacy rather than imprudence or inefficiency at the micro-financial level (Agarwala,2008). Equally, in the resultant competitive context, freedom of executive management and its ability to respond to the dynamics of a fast changing business environment will be the new success factors. Corporate Governance as a working tool for improving the overall effectiveness of corporate enterprises has found wide acceptability in the corporate world in India.

The impact of global financial crisis on India can broadly be divided into three different aspects:

- i) The immediate direct impact on its financial sector;
- ii) An indirect impact on economic activities, and
- iii) Potential long term geopolitical implications.

The intensification of the global financial crisis, following the bankruptcy of Lehman Brothers in September 2008, has made the current economic and financial environment a very difficult time for the world economy, the global financial system and for central banks. The fall out of the current global financial crisis could be an epoch changing one for central banks and financial regulatory systems. Since the great depression of 1929, the world has witnessed hundreds of such crises and the frequency of the crises has increased over time. According to a World Bank study of 2001, there were as many as 112 systemic banking crises from the late 1970s until 2001. Most of them, including the current one, have shared some common features: they each started with a hasty process of financial sector reforms, which not only created a vacuum in terms of regulations but also deteriorated the basic economic fundamentals though massive inflows of foreign capital and finally ended up with a change in investor expectations and a consequent mess in the financial markets. The financial sector crisis that arose in the latter half of 2007 and was precipitated by the collapse of Lehman Brothers on 23 September 2008 shared most –if not all– of these features. India, being an integrated part of the global economic order, was also exposed to the adverse impact of the global economic crisis. The crisis is global actions are national; benefits could be universal, but burdens in future on their account have to be incurred at national level exit is essential as the risks to growth abate and inflation risks emerge and intensify. The timing of exist is critical since premature exist may derail recovery and growth while a delayed exist may feed inflation and threaten growth over the medium term (Reddy, 2009).

Definition:

“Corporate Governance is the system by which organisations are directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance.”

Organisastion for Economic Co-operation and Development (OECD), April 1999

Concept of financial crisis:

If there is one major lesson to draw from the financial crisis, it is that corporate governance matters. The financial crisis has revealed severe shortcomings in corporate governance. When most needed, they often failed to provide the checks and balances that companies need in order to cultivate sound business practices. The financial crisis in emerging markets, lack of monitoring controls within corporate, governmental oversight in tracking misappropriation of funds, combined with financial failures among the firms have brought the topic of corporate governance for academia to acceptance in industry and capital markets. The various causes of global financial crisis are:

❖ **Proximate causes**

- ✓ Sub-prime lending
- ✓ Originate and distribute model
- ✓ Financial engineering, derivatives
- ✓ Credit rating agencies
- ✓ Lax regulation
- ✓ Large global imbalances

❖ **Fundamental cause**

- ✓ Excessively accommodative monetary policy in the US and other advanced economies (2002-04)

Global Financial Crisis

Current Account Balance (per cent to GDP)

COUNTRY	1990-94	1995-99	2000-04	2005	2006	2007	2008
China	1.4	1.9	2.4	7.2	9.5	11.0	10.0
India	-1.3	-1.3	0.5	-1.3	-1.1	-1.0	-2.8
Russia	0.9	3.5	11.2	11.0	9.5	5.9	6.1
Saudi Arabia	-11.7	-2.4	10.6	28.7	27.9	25.1	28.9
United Arab Emirates	8.3	4.6	9.9	18.0	22.6	16.1	15.8
United States	-1.0	-2.1	-4.5	-5.9	-6.0	-5.3	-4.7
<i>Memo:</i>							
Euro area	n.a.	0.9	0.4	0.4	0.3	0.2	-0.7
Middle East	-5.1	1.0	8.4	19.7	21.0	18.2	18.8

Source: World Economic Outlook Database, April 2009, International Monetary Fund.

Note: (-) indicates deficit.

Impact of the global crisis on India:

The impact of the global crisis on India can broadly be divided into three different aspects: (1) the immediate direct impact on its financial sector; (2) an indirect impact on economic activities; and (3) potential long-term geopolitical implications. Fortunately, India, like most of the emerging economies, was lucky to avoid the first round of adverse affects because its banks were not overly exposed to subprime lending. Only one of the larger private sector banks, the ICICI, was partly exposed but it managed to counter the crisis through a strong balance sheet and timely government action. The banking sector as whole maintained a healthy balance sheet and, over the third quarter of 2008 –a nightmare for many big financial

institutions around the world–, India’s banks reported encouraging results and witnessed an impressive jump in their profitability (Vashisht & Pathak, 2009). The direct effect of the global financial crisis on the Indian banking and financial system was almost negligible, thanks to the limited exposure to riskier assets and derivatives. The relatively low presence of foreign banks also minimised the impact on the domestic economy. However, the crisis did have knock on effects on the country, broadly, in three ways. First, the reduction in foreign equity flows – especially FII flows – impacted the capital and forex markets and the availability of funds from these markets to domestic businesses; second, the shrinking of credit markets overseas had the impact of tightening access to overseas lines of credit including trade credit for banks and corporate. Both these factors led to pressure on credit and liquidity in the domestic markets with the knock on effects, and third, the fall in global trade and output had impact on consumption and investment demand. The cumulative impact of all this was a slowing down of output and employment. Despite the slowing down, India is still the second fastest growing economy in the world. India with its complexities and sizeable market is a great preparation ground for companies to hone their skills and learn to deal with a culturally diverse populace. Being intensely competitive and price sensitive at the same time, the market forces companies to develop innovative mechanisms that result in lean cost structures. (Singh, 2008).

Impact of us financial crisis on Indian outsourcing companies:

Almost 60% of the total business of Indian IT and outsourcing industry comes from the US and the UK and therefore any tumults in those economies reflect with proportional ripples. An industrial production declines, unemployment rates have shot up in the United States. It has continued to affect the Indian industries as well. The IT outsourcing boom has created a buzz in the Indian economy. Jobs were created, unemployment rates declined, IT salary increased along with cost of living, real estate prices soared and so on. Indian outsourcing industry was making a progressive advance towards more quality oriented business operations and climbing up the value chain. The BPO sector was making a shift in terms of value addition towards KPO. The slowdown in US economy is making it necessary for Indian companies to look for business opportunities outside US in countries of Asia Pacific, Europe, Africa and Middle East. The economic conditions have led many investment banks to convert themselves into commercial ones. Due to the global economic slowdown, US companies will reduce IT outsourcing. As a result of reduced business, Indian outsourcing companies may take to reducing the number of employees in order to balance the low demand figures.

Concept of corporate governance:

“Corporate governance is the enhancement of corporate performance through supervision, monitoring of management performance and ensuring the accountability of management to shareholders and stakeholders.

***Teh Kok Peng, President, GIC Special Investments, Singapore
(Comment made at ACGA’s first annual conference, Hong Kong, Nov. 1, 2001)***

Financial crisis and its impact on Indian companies:

Globalisation and India becoming the world bestseller have driven many a company on to the corporate governance path. Indian companies are seeking to raise capital from foreign shores. The current economic crisis, which originated in the financial sector of the United States, is being transmitted to the countries around the world through three principal channels. First it has directly impacted the balance sheets of financial institutions that invested in the mortgage-backed securities and their derivatives, which turned toxic following large scale defaults in the US housing market. Secondly, the crisis has created a liquidity crunch. The US firms seeking liquid resources massively withdrew their investments in stocks and bonds in other countries. Thirdly, the final source of transmission of the crisis has been the real sector now frequently referred to as the 'Main Street' in the United States. The financial crisis coincided with the creeping recession in the United States and made it worse.



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Managers are generating large cash flows but have limited opportunities for value creating (positive NPV) investment projects, tend to destroy share owner wealth by investing too much capital back into their existing business and/or making ill-conceived and over-priced acquisition forays into unrelated areas. The managers tend to 'fix' the game for their own benefit rather than think of the long-term interest of the shareowners. Many private sector organizations around the world have found the implementation of the EVA framework a far more effective internally driven initiative to improve governance as compared to compliance mechanisms or transaction driven alternatives. It has to be remembered that key elements of good corporate governance principles include ***Honesty, Trust, Integrity, Openness, Performance Orientation, And Responsibility Along With Accountability, Mutual Respect, And Commitment To The Organization.*** Most important thing is to recognize the fact that corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. After

clocking an average of 9.4 per cent during three successive years from 2005-06 to 2007-08, the growth rate of real GDP slowed down to 6.7 per cent (revised estimates) in 2008-09. Industrial production grew by 2.6 per cent as compared to 7.4 per cent in the previous year. In the half year ended March 2009, imports fell by 12.2 per cent and exports fell by 20.0 per cent. The trade deficit widened from \$88.5 billion in 2007-08 to \$119.1 billion in 2008-09. Current account deficit increased from \$17.0 billion in 2007-08 to \$29.8 billion in 2008-09. Net capital inflows at US\$ 9.1 billion (0.8 per cent of GDP) were much lower in 2008-09 as compared with US\$ 108.0 billion (9.2 per cent of GDP) during the previous year mainly due to net outflows under portfolio investment, banking capital and short-term trade credit. As per the estimate made by the RBI in its Annual Policy announced on April 21, 2009, GDP is expected to grow by 6 per cent in 2009-10 (Thorat,2009).

Corporate Governance vs. Kumarmangalam Birla report:

The objective of the committee was "enhancement of the long-term shareholders' value while at the same time protecting the interests of other stakeholders." The key recommendations of the report were:

1. Board of Directors:

It provides leadership, strategic guidance and objective judgment independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders. The Board has five basic responsibilities:

- ❖ Overseeing Strategic Development and Planning
- ❖ Management Selection, Supervision and Upgrading.
- ❖ Maintenance of Good Member Relations
- ❖ Protecting and optimizing the Organizations' Assets.
- ❖ Fulfilling Legal Requirements.
- ❖ Attendance□ of each director at the BoD meetings and the last AGM.
- ❖ Number of BoD meetings held, dates on which held.

2. Audit Committee:

- ❖ Brief□ description of terms of reference
- ❖ Composition,□ name of members and Chairperson
- ❖ Meetings□ and attendance during the year

3. Remuneration Committee:

- ❖ Brief description of terms of reference
- ❖ Composition, name of members and Chairperson
- ❖ Attendance□ during the year
- ❖ Remuneration policy
- ❖ Details of remuneration to all the directors, as per format in main report.

4. Shareholders Committee:

- ❖ Name□ of non-executive director heading the committee
- ❖ Name□ and designation of compliance officer
- ❖ Number of shareholders complaints received so far
- ❖ Number not solved to the satisfaction of shareholders
- ❖ Number of pending share transfers

5. General Body meetings:

- ❖ Location and time, where last three AGMs held.
- ❖ Whether special resolutions
- ❖ Were put through postal ballot last year, details of voting pattern
- ❖ Person who conducted the postal ballot exercise
- ❖ Are proposed to be conducted through postal ballot
- ❖ Procedure for postal ballot

6. Disclosures:

- ❖ Disclosures on materially significant related party transactions i.e. transactions of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of company at large.
- ❖ Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

7. Means of communication:

- ❖ Half-yearly report sent to each household of shareholders.
- ❖ Quarterly results
- ❖ Which newspapers normally published in.
- ❖ Any website, where displayed
- ❖ Whether it also displays official news releases; and
- ❖ The presentations made to institutional investors or to the analysts.
- ❖ Whether MD&A is a part of annual report or not.

8. General Shareholder information:

- ❖ AGM: Date, time and venue
- ❖ Financial Calendar
- ❖ Date of Book closure
- ❖ Dividend Payment Date
- ❖ Listing on Stock Exchanges
- ❖ Stock Code
- ❖ Market Price Data : High., Low during each month in last financial year
- ❖ Performance in comparison to broad-based indices such as BSE Sensex, CRISIL.
- ❖ Registrar and Transfer Agents
- ❖ Share Transfer System
- ❖ Distribution of shareholding
- ❖ Dematerialization of shares and liquidity
- ❖ Outstanding GDRs/ADRs/Warrants or any Convertible instruments.
- ❖ Plant Locations
- ❖ Address for correspondence

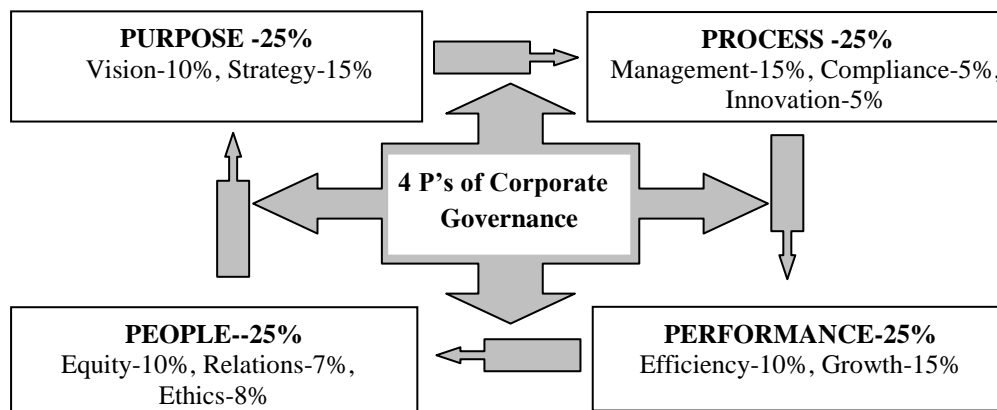
Future outlooks of Indian banks for better poised to cope with global financial crisis:



Indian banking industry is better placed to cope with the current adverse consequences of the ongoing financial turmoil in the West. Our banking industry is subject to stricter prudential regulations with respect to capital and liquidity. The Central Bank of the country i.e., Reserve Bank of India has imposed prudential limits on bank’s purchased inter-bank liabilities and these limits are linked to their net worth. In order to strengthen capital requirements, the credit conversions factors, risk weights and provisioning requirements of specific off-balance sheet items, including derivatives have been reviewed in the last few years. Moreover, in India, complex structures like synthetic securitization have not been permitted so far. Reiterating that India’s banking industry was quite healthy and as much as 34% of its deposits are in government securities and cash with the RBI. Their consumer loan to GDP ratio is just 10%, where as this ratio is as high as 100% for the US. The banking sector, through its overseas branches, has some exposure to distressed financial instruments, and troubled financial institutions. But this exposure is part of the normal course of their business and is quite small relative to the size of their overall business. Indian markets are witnessing today is an indirect, knock-on effect of the global financial situation. This is only a reflection of the uncertainty and anxiety in the global financial markets.

Corporate Governance Model:

Corporate governance mechanisms differ as between countries. The governance mechanism of each country is shaped by its political, economic and social history as also by its legal framework. Despite the differences in shareholder philosophies across countries, good governance mechanisms need to be encouraged among all corporate and non-corporate entities. Following figure indicating the rating scores for 4P’s of corporate governance:



Conclusion:

The global financial crisis has forced banks to take a critical look at how they manage risk and has exposed some significant weaknesses in risk management across the financial services industry. Good corporate governance is a journey and not a destination. It is a rewarding journey for those who choose the right path. Effectiveness of corporate governance system cannot merely be legislated by law neither can any system of corporate governance be static. As competition increases, technology pronounces the death of distance and speeds up communication; the environment in which firms operate in India also changes. India's geopolitical location is such that the financial crisis presents it with many challenges as well as opportunities. India will be able to tackle the challenges and make the most opportunities is impossible to predict at present. The financial crisis has forced banks to take a critical look at how they manage their risk and has exposed some significant weaknesses in the risk management across the financial services industry. As the Indian corporate scene is gradually transforming to cope with globalization, liberalization and privatisation, stakeholders are getting restless to prevent corporate board from offering them inferior deals. In the recent years, the regulators and legislators have intensified their focus on how businesses are being run. Effectiveness of corporate governance system cannot merely be legislated by law neither can any system of corporate governance be static. As competition increases, the environment in which firms operate also changes and in such a dynamic environment the systems of corporate governance also need to evolve. Failure to implement good governance procedures has a cost in terms of a significant risk premium when competing for scarce capital in today's public markets.

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