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Independent Directors - Special Reference of Corporate Governance and Indian Banking

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ABSTRACT

The origin of independent directors should be discussed from the ownership of company vis-à-vis Management. The Board is a group of individuals appointed by the owners of the company to run the company in the interest of the stake holders. A company is a combination of various stake holders such as investors, employees, vendors, customers, governments and society at large. The management of the daily affairs of the company is given to the Board of Directors. The concept of independent directors arose when the regulators all over the world felt the need for checking the insider game among the members of board of directors. It was assumed that they would usher in an era of transparency in the management of corporations. While it has been found true to a great extent, a set of scams, fraudulent practices that dented the image of big corporations tend to undermine the basic meaning of the nature of functioning of independent directors. The Satyam fiasco in which the independent directors were supposed to be torch bearers of corporate governance where found under an embarrassing situation and had to step down under disgrace , put a question mark in the Indian scenario. Instances of auditors of yesteryears being appointed as independent directors, the same individual being in the post for several years – in these two situations can the individuals come real independence in discharging the functions for which they are meant to. The move by Government of India to put a liability clause on the independent directors has put on spot light the question of freedom given by the corporate houses management.

KEYWORDS : Corporate Governance, Independent Directors, issues of Independent Directors, banking

The Non-Executive Directors play a crucial role in implementing the principles of effective corporate governance. The business activities of the corporations are crossing the national boundaries and involve shareholders and investors from all around the globe. Therefore, there is an urgent need for appointment of independent officers at the top levels of company. The need for of Independent Directors has also arisen due to gradual changes in the mindset of the investors and shareholders. A common feature of such Companies is that they have systems in place,In other words they have a system of good corporate governance. It is important that insiders do not take undue advantage of their position and take unfair advantage. In order to prevent such situation, the demand for Independent Directors has risen during the recent years in India. Independent Directors can counterbalance managerial infirmities in the company. They would ensure legal and ethical behavior of the company. They are the source of well conceived long term decisions for the company. They are deemed to provide the necessary personal and technical expertise in order to abate fraud, misappropriation by the company or its directors.

"Impartial. Unable to perceive any promise of personal advantage from espousing either side of a controversy."(Ambrose G. Bierce, 19th century American writer).

Independent directors are the cornerstones of good corporate governance. The presence of independent representatives on the board, capable of challenging the decisions of the management, is widely considered as a means of protecting the interests of shareholders and, where appropriate, other stakeholders. Theirs is the duty to provide an unbiased, independent, varied and experienced perspective to the board.

The Board is a group of individuals appointed by the owners of the company to run the company in the interest of the stake holders. A company is a combination of various stake holders such as investors, employees, vendors, customers, governments and society at large. The management of the daily affairs of the company is given to the Board of Directors. The representatives on the Board should run the affairs in a transparent manner to all its stakeholders. This is the triggering point for independent behavior of the people on the Board for the common good.

Purpose of Independent Directors

The purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the Company, judgment that is not clouded by real or perceived conflicts of interest.

In each case where a director is identified as "independent" the board of directors will affirmatively determine that such director meets the requirements established by the board and is otherwise free of material relations with the Company's management, controllers, or others that might reasonably be expected to interfere with the independent exercise of his/her best judgment for the exclusive interest of the Company. In each case, the Company should consider changes tailored to those sorts of relationships that would impair a director's independence, taking into account the circumstances of the particular Company.

The importance of independent directors as a governance mechanism to protect shareholders' interests and safeguard managerial employment contracts is recognized worldwide. For instance, the OECD Principles of Corporate Governance suggests that company's board should provide independent and objective judgments on corporate issues, apart from the management.

The Combined Code and the Higgs report believe independent directors are essential for protecting minority shareholders and can make significant contribution to firm's decision-making. They indeed recommend that half of the board members, excluding the chairman, should be independent.

Governance Issues in Banking

There have been scams time and again in this country not to talk of scams of gigantic proportions even in the global economies. Each country has evolved its own solutions by enacting stringent laws to tighten the loopholes and to safeguard the interest of the investors. There is always a dilemma of conflict of interest in a company between the investors who look to optimum rewards and the Board of Directors and all the other stakeholders including employees and functionaries that go to make up a company. In the case of banking institutions, you will all agree with me that they are highly leveraged institutions who have access to cheap deposits in the form of current and savings banks accounts and fixed deposits and who inturn lend it to the needy borrowers. Over the centuries since banking took roots, a safe credit deposit ratio is defined in many textbooks somewhere between 60% and 65 %. The management of the banks has to take intelligent decisions in lending to the various categories of borrowers. Overtime, regulation became very important over these institutions and therefore, the concept of introducing a CRR and SLR to meet emergencies has come to stay world over. There are several models of regulation. In most of the countries it is the Central Bank, which is responsible for supervision over all the financial institutions and in some other countries a Regulator uniquely empowered by law known as a 'Financial Services Authority' looks after all the financial entities including banks and financial institutions. I am mentioning all these as a sort of a backdrop to the governance issues and a need for utmost probity and transparency in conducting the affairs of banks.

We have a large chunk of Indian Banking industry in the public sector domain although, more than a dozen institutions are listed on the

Stock Exchange and the public has widely dispersed shareholding in these listed banks. It appears Government has no intentions of giving up the majority shareholding. Side by side, we have behemoth State Bank of India with 59% equity held by Reserve Bank of India. Likewise, we have NABARD where RBI owns a significant portion of equity. It is true in cases of listed banks, there is a sort of overlap in the control as they have to necessarily fulfill the requirements of the Stock Exchange and also all the regulatory requirements prescribed by the Reserve Bank of India and within the ambit of Banking Companies Act, Reserve Bank Act, and Special Acts of Parliament by which they are created, like the SBI Act of 1955 when SBI was created, Act of 1959 when the subsidiary Banks of SBI were created, and the Nationalization of Banks Act in 1969 and its further amendments. Over a period of time, corporate governance has been implemented in one form or the other in both public and private sector Banks by creating the various committees of the Board, inducting professionals on to these Boards and taking informed decisions by a free and frank debate after a consensus emerges at the Board or its subcommittees. Such prescription may sound very idealistic, but it never happens in practice in the manner expected. You will all agree with me that it would appear at the surface, differential treatment is necessary in dealing with governance issues between public sector and private sector, while the principles are the same.

Literature Review-

Sarbanes-Oxley, (USA): An independent director is a member who, other than in his capacity as a board member may not (a) accept any consulting, advisory; or other' compensatory fee from the company; or (b) be an affiliated person of the company or any subsidiary thereof and other advisers, as it determines necessary to carry out its duties.

The concept of "Independent Director' entered the corporate world en route through US, though in latent form, as "outside director" supposed to fulfill the advisory role. The genesis of actual Independent Director's (IDs) began only in 1970s, as part of CG reforms to fulfill the monitoring role. During this transition period, concept of IDs get widespread currency, and so is, their rise on boards and various mechanisms to enhance the independence criteria. The position of Independent Director's consolidated in the CG framework during hostile takeover period, with recognition of their role in enhancing shareholders prosperity. Subsequently, number of frauds in UK resulted in commissioning of Cadbury Committee on CG in 1992, which provided broadened definition of ID, their role and relation in the company. In 1997, Hampel committee (UK) and Blue Ribbon Committee (US), further defined and enhanced the role of Independent Director's.

After introducing the independent director system, the remaining question is, "Will firm have better performance by having independent directors on the board?" Studies from the West show that there are some controversial views on the effectiveness of board independence in relation to firm performance.

Lee, Rosenstein and Rangan (Lee et al., 1992) support this view, provide evidence that boards dominated by outside directors are associated with higher returns than those dominated by insiders. Similarly, Pearce and Zahra (1992) point out that there is a positive correlation between the proportion of independent directors and firm financial performance. Baysinger and Butler (1985) report that changes in board composition over a ten-year period from 1970s to 1980s appear have a causal relationship with accounting performance. In addition, Millstein and MacAvoy (1998) find a statistically significant relationship between active, independent boards and superior firm performance.

On the other hand, scholars such as Patton and Baker (1987) question the resolve of outside directors to actively monitor top management who often select them as candidates for their board seats. Some recent studies offer hints that firms with a high percentage of independent directors may perform worse. Started with Yermack (1996), he reports a significant negative correlation between proportion of independent directors and contemporaneous Tobin's Q. Furthermore, Rosenstein and Wyatt (1997) argue that insiders are more effective because they have superior knowledge of the firm and its industry than outside directors, and they are just as diligent as outside directors, given their legal responsibilities and their own interests in the firm. Similarly, Bhagat and Black (1999) also state there is no convincing evidence suggesting that greater independence results in better performance, but some evidence shows that firms with supermajority independent directors perform worse than others.

A meta-analysis conducted by Dalton, Daily, Ellstrand, and Johnson in 1998, which included 159 studies covering 40,160 companies over more than 40 years. They concluded that 'empirical work in the area does not provide consistent guidance on the relationship between company performance and board independence' (Daily and Dalton, 1998, p.7).

The role of independent directors as effective monitors and controllers of firm's management is perceived by many researchers. Fama and Jensen (1983) view that outside directors who hold multiple directorships have a greater incentive to monitor corporate performance because the professional directors have a personal investment in establishing their reputations as decision making experts. Additionally, outside directors may reduce managerial consumption of perquisites (Brickley and James, 1987), will not be intimidated by the CEO (Weisbach, 1988), and act as a positive influence over the directors' deliberations and decisions (Pearce and Zahra, 1992).

Moreover, the importance of independent directors as a governance mechanism to protect shareholders' interests and safeguard managerial employment contracts is recognized worldwide. For instance, the OECD Principles of Corporate Governance (1999) suggests that company's board should provide independent and objective judgments on corporate issues, apart from the management. The Combined Code and the Higgs report believe independent directors are essential for protecting minority shareholders and can make significant contribution to firm's decision-making. They indeed recommend that half of the board members, excluding the chairman, should be independent (Combined Code, 2003; Higgs, 2003).

TERMS LIMIT FOR INDEPENDENT DIRECTORS IN PUBLIC BANK-

Independent directors on the board of state-owned banks will soon have a maximum tenure of six years, a move that the government hopes will make them more effective and improve corporate governance.

"The plan to restrict the tenure of directors on bank board's has received the approval of the finance minister," a ministry official said, requesting anonymity.

P. Chidambaram, after returning to the finance ministry in August, promised public-sector banks more autonomy is making decisions, which also means making their boards stronger and more efficient.

The ministry in July had asked the nationalized lenders to only discuss important issues such as strategic business plans, bad debt management, and human resource planning and core business operation in board meetings.

The government's move is in line with the provisions of the proposed companies' law, which restricts the tenure of independent directors to not more than 10 years, according to J.N. Gupta, founder and managing director of Stakeholder Empowerment Services, an advisory.

"Effectiveness of the board is a key part of corporate governance, provided the right people are selected," Gupta said. "The way the shareholder directors are sometimes appointed shows that there is still a long way to go to ensure that all stakeholders are adequately informed about the consequences of the decisions they are taking."

The move to restrict tenure would also mean that a director, whether nominated by a shareholder or the government, will be ineligible for further appointment to the board of any public-sector bank, if the person has already served for six years at one of them.

"There have been instances when a person has been on the board of bank for years in some capacity or the other. If the government refuses to appoint a person to a bank's board, he becomes a shareholder director and joins the board," said another finance ministry official, who too declined to be named. "By restricting the tenure, we can ensure that one person doesn't hop from one bank board to another."

A board of a public-sector lender comprises the chairman and managing director, executive directors, a director nominated by the government (typically a finance ministry official), another one nominated by the RBI, some three appointed by shareholders and a couple of non-official directors. The state-owned banks, depending on size, generally have around 11-14 directors on their boards.

As a majority stakeholder, the Central government constitutes the boards of nationalized banks, with the majority of directors, including the chairman and managing director, being appointed by the finance ministry. The director nominated by the central bank and those representing other shareholders are the only ones not directly appointed by the government.

The government may also insist on banks having directors from different specialized fields to bring in varied expertise. At present, chartered accountants dominate bank boards.

"Bank boards' should have expertise across fields like economics, finance, human resource and information technology," the second official said. "It should not be restricted to any particular profession."

Conclusion

Mostly many times in the past, it has been observed that the members of the Board have taken decisions prejudicial to the interests of the stakeholders at large and ran the corporations for the material benefits of the few. This called for independent members on the Board in the process of adopting fair and transparent business practices.

The Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and financial markets acquire greater depth. I can assure The real success of our financial sector reforms will however depend primarily on the organizational effectiveness of the banks, including cooperative banks, for which initiatives will have to come from the banks themselves.. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business areas like micro finance, commitment to better customer service by the independent directors.

The revised clause 49 of the Listing Agreement is, therefore, most timely and provides much needed disclosure requirements, widened definition of independent director, periodical review by independent director, whistle blower policy, quarterly compliance report in the prescribed format and issue of certificate of compliance. It is hoped that the revised clause 49 would go a long way in providing corporate good governance framework.

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