Board Reforms in PSBs – Some Pointers from the Nayak Committee

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The committee to review governance of boards of banks in India (Nayak Committee) submitted its report recently. In the context of several issues concerning capital, risk management, human resources, board constitutions, the RBI constituted this committee to have a comprehensive look and suggest ways and measures to strengthen the governance both in PSBs as well as private banks. In this article I will mainly deal with the governance issues in PSBs.

The Nayak Committee has made bold observations about the state of governance in PSBs. It observes that financial position of PSBs is fragile and the boards of most banks lack focus on business strategy and risk management and they are not able to provide oversight to steer the banks through their present difficult position. The boards are disempowered and the selection process for Directors is increasingly compromised and therefore board governance is consequently weak. The report proposes that the governance should distance itself from several bank governance functions which currently it discharges and for this purpose it recommends that the Bank Nationalization Acts of 1970 and 1980 together with the SBI Act and the SBI (Subsidiary Banks), act be repealed and all banks be incorporated under the Companies Act and a bank investment company be constituted to which the government transfer its holding in banks. The government's powers in relation to the governance of banks should also be transferred to BIC.

It also suggests constitution of Bank Board's Bureau (BBB) comprising former senior bankers to advice on all board appointments. The committee has also proposed to reduce government stake in these banks to less than 50%. Apart from these recommendations, the report has also proposed wide ranging Human Resource policy changes. There are wide spread criticism of the Nayak Committee report. Bank Unions whose track record is to oppose any reforms have on expected lines reacted strongly against the report. It may be pertinent to mention that they also strongly opposed implementation of Khandelwal Committee on Human Resources in Banks which this author had the privilege of chairing. Some sensitive observers have observed that what Nayak Committee has proposed is actually "Bank privatization by the backdoor" (TT Ram Mohan). It is contended that government ownership does not render PSB performance inferior to that of private banks. Bank performance in India has been to a large extent ownership neutral. It is important to realize that in recent times, divergence in performance has been caused by PSBs heavy investment in infrastructure.

Key Issues in Governance

1) Government Control

In the current political context, it sounds impractical that government would accept committee's recommendation to bring down the stake of the government below 50% and hand over the functions of appointment of CEOs and Directors to a new entity as proposed by the committee. In fact a whole lot of changes are possible within the existing structure. Many of the problems have arisen on account of inconsistent, ad-hoc and micromanagement approach of the government in dealing with public sector banks. The government needs to act professionally and relook into in following areas:

Appointment of full time board members

Government appoints Chairman and Executive directors as full time board members in PSBs. The selection for these positions is quite nebulous and lacks rigor. Although on paper the committee is headed by the Governor of Reserve Bank of India but in practice the governor is represented by a Deputy Governor. This dilutes the role of regulator. Elsewhere for example, in UK, FSA (Financial Services Authority) interviews the prospective bank Chairman. Further, the selection criteria are often changed to accommodate individuals, thereby severely denting the credibility of the appointment process in such high positions. It is during this time that the prospective candidates for CMD ED position lobby in the corridor of powers for their selection and placement.

The candidates for the highest office in PSBs are selected through a short interview process alone. One would expect that there would be some rigor in the selection process. In this context Khandelwal Committee (2010) recommended that the prospective candidates must undergo the assessment center process before they appear for the interview but for reasons of expediency , the selection process remain what it is. In this system, there are frequent changes in different banks and even large banks are not able to develop their own cadre to head their respective banks as no effort is made to actually plan succession for higher positions. From 2008 onwards, there is a massive exodus of top bankers due to super annuation and there have been very fast promotions to fill in these positions.The implication isthat executives with limited period spent in DGM and GM cadre are elevated as ED and CMD.without adequate level of experience and leadership preparation. This is fraught with different kind of risks. Lack od succession planning at government level and worst still nebulous and ad-hoc process of selection for top positions goes at the very root of governance.

Tenure of Appointment and compensation

Often even in large banks the tenure of CMDs and EDs is rarely over 3 years. During such limited time, they are not able to initiate any long-term changes. In this context the Nayak committee has rightly proposed that the tenures of CMD should be minimum 5years and 3 years respectively.

I would only add that the performance of full time board members should be

Rigorously assessed every year on rigorously in the context of not only business but the foundational steps that they have undertaken in the area of building leadership pipeline, human resources, brand building, ethical business practices and governance. Long tenure by itself does not guarantee good performance, although it helps taking long term steps and therefore the CEOs should be assessed on both tangible business results and contribution to building an architecture of intangibles.

It is time that a serious attention is paid to the issue of compensation of CMD and ED and other senior executives. The compensation be based on the concept of CTC and variable pay, which is now a common practice in organizations. Khandelwal committee had recommended a scheme of incentives to CMDs and EDs and other stff. It is time to put it in practice. Given the responsibility and risk level of PSU bankers, current level of compensation of the top management is indeed very low and need revision.

Board competence:

The performance of Bank board's lack discussion on strategy and long term issues as rightly observed in the Nayak Committee. The discussions are predominantly on issues brought up by the CMD to the board. As the quality of Board deliberation across firms is sensitive to the skills and independence of board members, it is imperative to upgrade these skills in board of PSBs by reconfiguring the entire appointment process of boards (Nayak Committee). The scheme of board constitutions is provided in the Bank Nationalization Acts of 1970 and 1980, and since then there has been no change not withstanding massive changes in the structure and delivery of banking services. It is a matter of concern that governments of the day have also been nominating political activists on bank boards. The nominees of the government are also exempted from the normal fit and proper criteria and in effect the bank boards do not have any independent director as is rightly observed by Nayak Committee. Bank board's lack domain knowledge in the areas like technology, risk management, strategy and human resources. The process of board appointments, including appointment of whole time directors need to be professionalized to ensure that banks are board driven and board is able to exercise over sight on the management.

Splitting the role:

Another recommendation of the Nayak Committee which deserves serious consideration is the separation of the position of bank Chairman and CEO. Lessons from the recent global crisis should guide corporate governance practices in Indian PSBs also. With the current structure of the boards of PSBs, it will not be an overstatement to say that the CMDs are all too powerful to set the direction for the Banks and depending on its priorities and specialization, the Banks sets its agenda. Banks being financial entities holding public money and trust require oversight at every level to preserve the confidence of the people. A non executive chairman of exceptional ability can make a huge difference to look beyond quarter to quarter performance to strategic focus and set direction for long term future of the organization apart from redefining the relevance and purpose of the organization. He can bring external world perspective into board discussions, focus on competition and present credible and authentic competitive strategy and pursue applicable corporate government standard and practices (Khandelwal2011). We have examples of such a model pursued by major private sector banks in the country. There the system is currently functioning successfully.

In financial institutions like Banks, the issues of ethical conduct across the organization and more particularly at the top should be ensured. This would mean not a witch hunting type vigilance but a sturdy system that is effective in enforcing the faith of bank executives in such a system

The recommendations of Nayak Committee and Khandelwal Committee should be read together as the governance on the bedrock of good human resource practices alone can deliver. Both the reports are complimentary in many ways to create a sound system of governance in India's public sector banking system.

It is believed that board reforms are precursor to effective functioning of PSBs and improving stakeholder value. Each of the reform measures suggested as above is doable and is in the long term interest of creating stability of PSBs. It is in the interest of government itself to strengthen the system of governance in PSBs to ensure stability of the our banks.

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