Case Study

Corporate Governance in Indian Banking Industry: An Experience with SBI and HDFC Bank

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The role of Corporate Governance (CG) has become an essential part of the corporate disclosure practice of any successful organization. The most accepted corporate mantra today is that the better the CG practice of an organization the better the shareholder and stakeholder value creation. The same is also applicable to the emerging financial sector of the country, particularly the banking industry. The entry of new private and foreign bankers has made the industry more competitive; at the same time, the role of CG has become more important from the point of view of protection of the stakeholder interest. In this paper an attempt is made to make a detailed comparative study of the CG practice of two leading banks based on their annual report for the financial year 2006-07. The banks under study were The State Bank of India (SBI) and The HDFC Bank Ltd., the former is a leading public sector bank whereas the latter one is a leading private bank. The study is based on the report of CG given by the Narayana Murthy Committee on CG.

Introduction

As per the Organization for Economic Cooperation and Development (OECD) documents (1999), Corporate Governance (CG) is the system by which organizations are directed and controlled. The CG structure specifies the distribution of rights and responsibilities among different stakeholders of the corporation, such as board, managers, shareholders and employees, and spells out the rules and procedures for making decisions on corporate affairs. In this process of distributing responsibilities, it also provides the structure through which the companies can visualize the objectives, define the means of attaining those objectives and monitoring performance.

Gopal (1998) argued that the increasing efficiency of capital markets and global mobility of funds across the world means that the opportunity cost of shareowners' funds is increasingly real. If Indian corporates do not perform better then the investors, especially Foreign Institutional Investors (FIIs), will look elsewhere.

Aravanan (2001) suggested that CG is basically a system of making directors accountable to the stakeholders for the effective management of the companies, with concerns for ethics

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and values. This related to the management of companies by the Board of Directors, which reflects on complete transparency, integrity and accountability of the management comprising both executive and non-executive directors. Some important synonyms of this concept of CG are corporate disclosure, transparency or shareholders' value.

CG plays a prominent role in creating confidence and trust among the people concerned (Raju, 2003). The concept of CG has gained considerable currency in recent years all over the world (Christine Mallin, 2004). Several international organizations such as the World Bank, WTO, IMF and OECD, CII and different reports like Cadbury Report (1992), Greenbury Report (1995), Hampel Report (1998), Combined Code (1998), Turnbull (1999), Myners (2001), Higgs (2003), Smith (2003), Combined Code (2003) and OECD Principles of CG (1999) have been developing policies to strengthen the management of the corporate world.

Need for Corporate Governance

Due to the separation of ownership from management, the primary responsibility for running a business with integrity and honesty lies with the managers who are accountable to the shareholders and investors. Vast majorities of Indian corporates are controlled by promoters' families, which while owning a negligible proportion of share capital in their companies, rule them as if they are their personal kingdoms. This minority misgoverns the majority. In view of this misgovernance, corporate concepts like democratic management, professional management, transparent operations, etc., have become myths.

The credibility of the corporate world was dented in the late 1990s in the United Kingdom due to a series of CG scandals like Maxwell. In response, a committee was set up in 1991 to look into the financial aspects of CG. The committee led by Sir Adrian Cadbury had submitted its report on CG in December 1992. The implementation of the recommendations of the Cadbury committee resulted in a new movement. Many other countries also setup their own committees to reform their CG system. The companies have also started taking a serious note of it because of globalization.

Now, corporates have access to opportunities worldwide but at the same time they also face the threat of the entry of global players in India (Agarwal, 1998). Due to scarcity of resources, attention is being given to the development of greater skills. There is an increasing awareness that the customers are the most important entity in any business. Increasingly, there is a growing realization that good CG is a must not just for gaining credibility and trust but also as a part of strategic management for survival, growth and consolidation.

But it cannot be assumed that everything is going well as far as the CG practices of the firms are followed. Although, many companies may manage to comply with the regulatory requirements for good CG, their stakeholders continue to get a raw deal. Hence, the authors prefer to view CG from an economic framework. Good CG ensures that managers run the business in the long-term interest of the stakeholders, and in doing so, ensures that all other stakeholders are also taken care of. To do this we need to take CG more seriously and find ways to acquire wealth that is destroying companies so as to: first improve their capital efficiency and, second, to harvest capital out of these areas so that it can be redeployed in more productive sectors of the economy.

Gopal (1998) argued that the report of the committees on CG activated CG movements in India also. The recent needs in CG in India can be owed to the following factors:

- Assertion of rights by a new breed of shareholders who are more discerning and objective;
- Significant presence of FIIs who expect international standards in CG, demanding greater professionalism in the management of Indian corporates;
- Concern on the part of lending institutions like banks and financial institutions about the functioning of companies financed by them; and
- Integration of Indian economy with the world economy, which demands that Indian industry, conforms to the standard set by international rules.

Need for CG in Banking

Banks constitute the largest financial intermediaries around the world and possess stupendous powers of leverage. Unlike in the rest of the corporate world, authorities like RBI and the government play a direct role in bank governance through bank regulation and supervision. This role is justified by the need to ensure systemic stability, financial stability and deposit insurance liability considerations. Banks enjoy the benefit of high leverage with the downside protection of deposit insurance, which weakens their incentives for strong management monitoring. While a ubiquitous form of corporate control and concentrated ownership will raise new barriers to effective CG, large investors may manipulate the firm contrary to the broad interests of the bank and other stakeholders.

The current trends lay stronger emphasis on risk measurement and management. Bank regulation and supervision should help shareholders. The banking regulators must make the boards the main locus of accountability and assess board effectiveness. Besides, the regulators need to ensure transparency in the operations of the banks to reduce information asymmetry. Although, information asymmetries affect all sectors, this problem is more complicated in the financial sector. In product or other service markets, purchasers part with their money in exchange for something new, whereas in finance, money is exchanged for a 'promise to pay' in the future. Besides, in many of the products or service markets, if the object sold—a television or a car repair service—is defective, the buyers can find it out relatively soon. However, loan quality is not readily observable for quite some time and can be hidden for extensive periods.

Banks and non-bank financial intermediaries can alter the risk composition of their assets also more quickly than most of the other business sectors. Moreover, banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. In most sectors, when inventories of 'stuff' pile up, be it cars, computers, or software, it is generally a negative signal about the company's performance. But, when 'inventories of money' pile up in a bank (it becomes more liquid), it is much harder to understand whether this is a negative signal or a prudent response by the management to a risky environment. Hence, governance in banks or financial sector firms is more complicated than any other business sector.

On the other hand, unlike any other business sector firms, governance problems in a bank can affect the entire financial system of the company. The collapse of one bank can trigger a series of failures in the whole economy. This is because unlike the firms of other sectors, the banks interact with each other to a greater extent. Hence, the necessity and importance of enforcing effective CG is very essential from the point of view of strengthening the financial system of the country.

Indian Context

The Indian CG is not self-regulating as is the case with the US, the UK and other capitalist economies. Here in India, the CG is to be directed in a way that creates a responsible business environment consistent with the present needs, requirements and challenges of the economy as a whole.

The Indian CG model is a mix of both Anglo-American and German CG models. The different organizations in India can be grouped into three categories: private companies, public companies and banks. In the CG system in India, the Board of Directors are being nominated jointly by shareholders, institutional investors, employees in some cases, nominee directors by the government, particularly in public sectors and banks.

The CG practice in India is largely influenced by the Kumarmangalam Birla Committee Report, CII Committee Report on desirable CG practice and the N R Narayana Murthy Committee Report on good CG practice. Both the Kumarmangalam Birla Committee Report and N R Narayana Murthy Committee Report on good CG practice are being formulated by the SEBI, therefore, the latest report formulated by SEBI—N R Narayana Murthy Committee Report on good CG practice—is being considered for the current study in this paper.

Corporate Governance Practice in State Bank of India

The State Bank of India has complied, in all material respects, with the CG Code as per clause 49 of the Listing Agreement with the Stock Exchanges for the financial year ended March 31, 2007. The bank also has well-defined CG code. It says, “The State Bank of India is committed to the best practices in the area of CG. The bank believes that proper CG facilitates effective management and control of business. This, in turn, enables the bank to maintain a high level of business ethics and to optimize the value for all its stakeholders”.

Board of Directors

The board is headed by the Chairman of the Bank. Two managing directors are also members of the board. As on March 31, 2007, there were 11 other directors (non-executive/official) as members of the board, comprising eminent personalities from academics, industries and accounting firms. They include representatives of Reserve Bank of India, shareholders and employees of the bank and other directors appointed according to various clauses of Section 19 of the State Bank of India Act, 1955.

Committees

The Board of SBI had constituted seven Committees of Directors—Executive Committee, Audit Committee, Shareholders'/Investors' Grievance Committee, Risk Management Committee of the Board, Special Committee of Directors for Monitoring Large Value Frauds, Customer Service Committee and Technology Committee of the Board.

Corporate Governance Practice in HDFC Bank Ltd.

Philosophy on Code of Corporate Governance

HDFC bank also had explicitly defined the code of CG. It says, "The bank believes in adopting and adhering to the best CG practices and continuously benchmarking itself against each such practice. The bank has infused the philosophy of CG into all its activities". The philosophy on CG is an important tool for shareholder protection and maximization of their long-term values.

Board of Directors

The annual report of HDFC bank 2006-07 highlights that the composition of the Board of Directors of the bank is governed by the Companies Act, 1956, the Banking Regulation Act, 1949 and the Clause 49 listing requirements of the Indian stock exchanges where the securities issued by the bank are listed. HDFC Board had nine Directors as on March 31, 2007. All the Directors, other than Mr. Aditya Puri, are non-executive directors. The bank had four independent directors and five non-independent directors. The annual report pointed out that the Board consisted of eminent persons with considerable professional expertise and experience in banking, finance, agriculture, small scale industries and other related fields.

The table describing the compliance of the governance practices of SBI and HDFC banks with respect to various parameters laid down by the Kumaramangalam Birla and Narayana Murthy Committee reports, is given in Appendix.

Conclusion

A detailed analysis of CG practice of SBI and HDFC Bank Ltd. (refer Appendix), reveals that the CG practice of both the banks are quite satisfactory, whereas the practice of each bank in a few areas are more satisfactory than the counterpart. At the same time, there is ample room and scope for improvement for the both the players in different areas of disclosure. HDFC bank's (privatized bank) application of CG is effective, as many parameters are satisfied as per clause 49 of listing agreement as well as the Narayana Murty Committee report in comparison with the nationalized bank, SBI, in this particular study. SBI is also having good CG practice but it lacks in certain areas in comparison with the private player (HDFC bank) in this study. It can be concluded that the disclosure practice of Indian private banks helps the stake holders to make an effective interpretation about the performance of their bank. In India the CG practices are improving year after year, particularly in the banking sector which is a good sign from the industry's perspective. The lead role is played by many corporate leaders like HDFC Bank, SBI, TATA Steel, ICICI Bank, Jet Airways, Infosys, etc. If the others follow the same strategy then the Indian corporate scenario will develop to the expected level. ❑

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Appendix

Corporate Governance and Disclosure Practices of HDFC Bank and SBI		
Basis of Comparison	**HDFC Bank**	**SBI**
Brief Statement on Companies' Philosophy on Code of Governance		
Philosophy on code of governance	Proper disclosure	Proper disclosure
Board of Directors		
Nature of Board	Proper disclosure; Chairman is non-executive and part time	Proper disclosure; Chairman is non-executive
Composition of the Board of Directors	Proper disclosure	Proper disclosure
Independent Directors and the definition of 'Independence'	Eight out of nine are non-executive directors, four independent and five non-independent directors; definition of independent directors is not disclosed	Proper disclosure; 10 out of 13 are non-executive directors and the definition of independent directors is not disclosed
Nominee Directors	Disclosure is not very clear, information is provided partly	Proper disclosure
Chairman of the Board	Shri Jagdish Capoor	Shri A K Purwar (upto May 31,2006), O P Bhatt (w.e.f. from July 1, 2006)
Attendance of each director at the BOD meeting	Proper disclosure	Proper disclosure
Number of BOD meetings held, dates	Eight Board Meetings were held on April 17, 2006; May 30, 2006; July 14, 2006; August 29, 2006; October 17, 2006; December 5, 2006; January 11, 2007; and March 29, 2007	Nine Board Meetings were held on May 19, 2006; June 8, 2006; June 30, 2006; July 27, 2006; August 24, 2006; October 28, 2006; December 26, 2006; January 23,2007; and March 22, 2007
Audit Committee		
Brief description	Proper disclosure	Proper disclosure
Composition, name of chairpersons	Proper disclosure, Shri Ranjan Kapoor, Chairman of the committee	Shri K P Jhunjhunwala, non-executive

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Corporate Governance and Disclosure Practices of HDFC Bank and SBI		
Basis of Comparison	**HDFC Bank**	**SBI**
Audit Committee		
Meetings and attendance during the year	No proper disclosure regarding the dates of the meetings held; Six meetings held	Proper disclosure; Seven meetings held during the year, dates are: May 27th, July 26th, September 30th, October 29th, December 30, 2004; January 27th and March 10, 2005
Independence	Proper disclosure; All are independent and non-executive	Proper disclosure; All are independent and non-executive
Frequency of meetings and forums	Proper disclosure; Two months	Proper disclosure; Less than two months
Powers of the audit committee	Proper disclosure	Disclosure is not very clear; information is provided partly
Functions of the audit committee	Proper disclosure	Proper disclosure
Remuneration Committee of the Board		
Brief description	Proper disclosure	No disclosure as there is no remuneration committee
Attendance during the year	One meeting held, Shri Jagdish Capoor is the chairman of the committee	No disclosure as there is no remuneration committee
Remuneration policy	Proper disclosure and transparent policy	No disclosure as there is no remuneration committee
Composition, quorum of the remuneration committee	No proper disclosure	No disclosure as there is no remuneration committee
Disclosure of remuneration package	Proper disclosure and transparent policy	No disclosure as there is no remuneration committee
Board Procedures		
Board meeting (At least four)	Proper disclosure; All attended a minimum of four meetings except Amla Samant and Vineet Jain	Proper disclosure All attended a minimum of four meetings.

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Corporate Governance and Disclosure Practices of HDFC Bank and SBI		
Basis of Comparison	**HDFC Bank**	**SBI**
Board Procedures		
Restriction of chairman-ship (five companies)	Proper disclosure; None of the director is the chairman of more than five committees	Disclosure is not very clear, only little information is provided
Restriction from membership (ten companies)	Proper disclosure; None of the director is the member of more than ten committees	Disclosure is not very clear, only little information is provided
Shareholder Committee		
Name of non-executive director heading the committee	Proper disclosure; Shri Jagdish Capoor is the chairman of the committee	Proper disclosure; Shri Suman Kumar Bery is the chairman of the committee
Name and designation of compliance officer	Proper disclosure, Shri Sanjay Dongra, V.P.(Legal), Company Secretary	Proper disclosure, Shri S K Nath (CGM – Accounts and Compliance)
Number of shareholders' complaints received in a year	Proper disclosure; 193	Proper disclosure; 3699
Number of complaints unsolved	Proper disclosure; Nil	Proper disclosure; 18 complaints which are sub-judice
Number of share transfers pending	Proper disclosure; 136	Disclosure is not very clear, only little information is provided
General Body Meetings		
Location and time of last three AGMs	Proper disclosure	Proper disclosure
Were special resolutions passed?	Proper disclosure	Disclosure is not very clear, only little information is provided
Details of voting patterns (physical and postal ballot)	Proper disclosure; Only physical voting, so no need of postal ballot system	Disclosure is not very clear, only little information is provided
Person who conducted postal ballot exercise	Proper disclosure; Not applicable	Disclosure is not very clear, only little information is provided.
Procedure for postal ballot	Proper disclosure; Not applicable	Disclosure is not very clear, only little information is provided

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Corporate Governance and Disclosure Practices of HDFC Bank and SBI		
Basis of Comparison	**HDFC Bank**	**SBI**
Disclosures		
Disclosure on materially significant related-party transaction	Proper disclosure; There are no materially significant related-party transactions which have potential conflict with the interest of the company at large	Disclosure is not very clear, only little information is provided
Details of non-compliance and penalties imposed on the company by SEBI	Proper disclosure; All requirements of stock exchanges and SEBI and other statutory authorities are duly complied. No penalties or strictures have been imposed by stock exchanges, SEBI	Disclosure is not very clear only little information is provided
Means of Communication		
Half-yearly report sent to each household of shareholders	Disclosure is not very clear, only little information is provided	Disclosure is not very clear, only little information is provided
Quarterly results,Which newspapers normally published in?	Proper disclosure; Quarterly and half yearly results (un-audited) are being published in *Business Standard* (English), and *Mumbai Sakal* (Marathi Regional)	All leading news papers of India, but it is not disclosed which particular news paper
Any website where displayed	Proper disclosure, www.hdfcbank.com this website also links to www.sec.gov where investors can view statutory filings of the bank.	Proper disclosure, www.sbi.co.in www.statebankofindia.com
Official news releases are displayed	Proper disclosure, www.hdfcbank.com www.sebiedifar.nic.in	Proper disclosure, www.sbi.co.in www.statebankofindia.com
General Shareholder Information		
AGM date, time and venue	June 17, 2005 (11th AGM), the time and venue is not disclosed	Proper disclosure, June 30, 2007, 3.30 p.m. Y B Chavan Centre, General Jagannath Bhosale Marg, Nariman Point, Mumbai
Financial calander	Proper disclosure, Year ending March 31st	Proper disclosure, Year ending March 31st
Date of book closure	Proper disclosure; May 28, 2005 to June 17, 2005 (both days inclusive)	June 15, 2007 to June 25, 2007, no disclosure of both day inclusive
Dividend payment date	Proper disclosure; June 18, 2005	Proper disclosure; July 20, 2007

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Corporate Governance and Disclosure Practices of HDFC Bank and SBI		
Basis of Comparison	**HDFC Bank**	**SBI**
General Shareholder Information		
Listing of stock exchanges	Proper disclosure; The BSE, Mumbai, The NSE, Mumbai	Proper disclosure; The BSE, The NSE, DSE, ASE, CSE, MSE and GDR in LSE; Listing fees payment – updated
Stock code	Proper disclosure, The BSE, Mumbai-500180 The NSE, Mumbai-HDFC BANK	Proper disclosure; 112
Market price data, i.e., high/ low during each month in last financial year	Proper disclosure, Data of high, low, avg.volume per day, avg.no. of trades per day, avg. value per day for the period April 2006 to March 2007	Disclosure is not very clear, only little information is provided
Performance through BSE, SENSEX, CRISIL Index, etc.	Proper disclosure	Disclosure is not very clear, only little information is provided
Registrar and transfer agents	Proper disclosure Mrs. V Sajan/Mr. S Manve/Mr. V Deshmukh MCS Ltd., Registrars and Transfer Agents, Unit: HDFC Bank, Shree Venkatesh Bhawan, Plot No. 27, Road No. 11, MIDC Area, Andheri(E), Mumbai-400093; Tel: 022-28215235/6/7; Fax: 022-28350456; E-mail: mcssvp@eth.net	Proper disclosure M/s Datamatics Financial Software and Services Ltd., Unit: State Bank of India, Plot A-16 and 17, MIDC, Part B, Cross Lane, Marol, Andheri(E), Mumbai-400093; No disclosure of Phone No., Fax No. and E-mail id
Share transfer system	Proper disclosure	Proper disclosure
Dematerialization of shares	Proper disclosure	Proper disclosure
Address for correspondence	Proper disclosure; HDFC Bank, 2nd Floor, Process House, Senapati Bapat Marg, Kamla Mills Compound, Lower Parel (W), Mumbai-400013; Tel: 022-24988484, 24961616 Ext. 3463; Fax: 022-24965235; E-mail: investor.helpdesk@hdfcbank.com	Proper disclosure; State Bank of India, Shares and Bonds Department, Central Office, State Bank Bhavan, 9th Floor, M C Road, Nariman Point, Mumbai-400021 No disclosure of Phone No., Fax No. and E-mail id

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