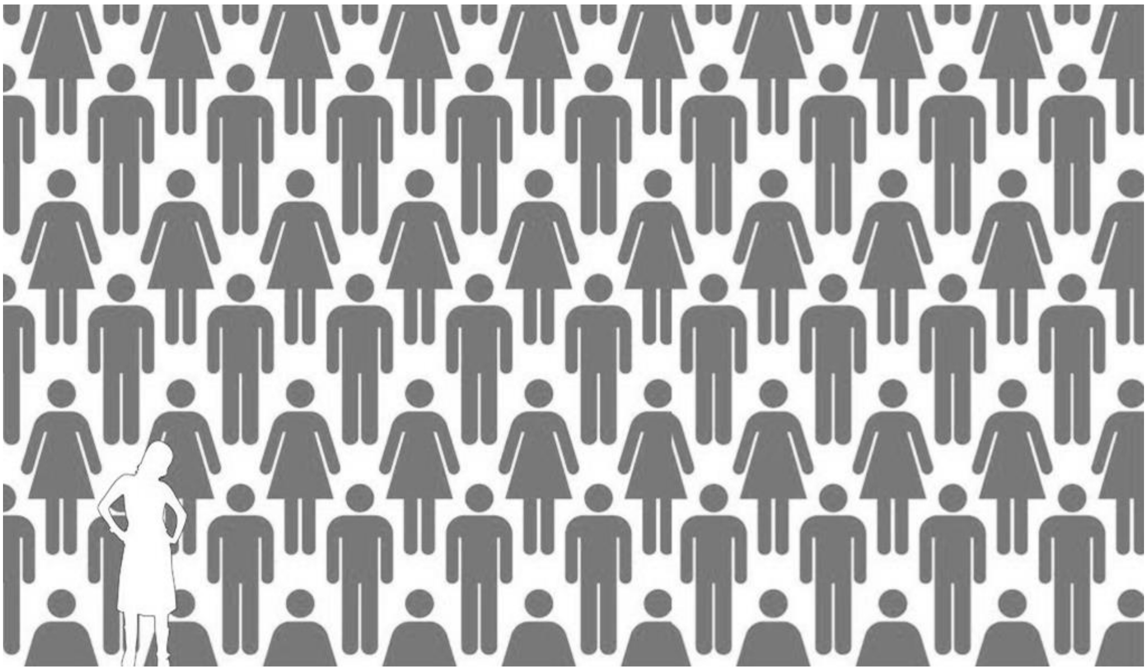
The new world of public interest directors

In his twin interactions with bank directors, RBI's governor did not ask them to maximize profits or focus on shareholder value. He asked that their judgements prioritize the stability and growth of the financial system.



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For companies the best time to borrow money is when they don't need to. For banks the best time to accumulate capital is when they don't need to. For banks the best time to strengthen processes is when times are good. It is this thinking that prompted Reserve Bank of India's Governor Shaktikanta Das to hold twin interactions on governance in banks. The first of these was with the boards of public sector banks and a week later, with the boards of private sector banks. He reminded the boards that "risks often get overlooked or forgotten when things are going well." Banks currently have a capital adequacy ratio of 16.1%, the highest in a long while, with gross and net non-performing assets or NPAs at 4.41% and 1.16% respectively, the lowest in a long while. This then is the best time to focus on and strengthen the governance process and structures.

The Governor drew out a 10-point charter to ensure the safety and stability of the banking system. He emphasized that the quality of governance and management is critical to a bank's success. He went on to list seven critical items that should be on the board's agenda. These are business strategy, financial reports and their integrity, risk, compliance, customer protection, financial inclusion and human resources.

Speaking about the independence and skills of the independent directors, the Governor stressed that the larger purpose of the Board is to provide clear and consistent direction to the bank and oversight over the senior management. Additionally, the board is also tasked with overseeing the Bank's corporate values. Setting the correct tone at the top will help build a conducive corporate and risk culture as well as ethical behavior among the employees.

As the customer deals with the bank, the board should ensure that the bank's practices are fair practices, the customer is paramount, grievance redress is quick and effective. RBI expects agreements with third parties to ensure that the primary responsibility remains that of the banks and not with the third parties.

There is far more to unpack in the speech than I have listed above. Those on company boards and those hoping to join one – and not just a banks board, must read the full text of the speech as well as the two by two of the Deputy Governors, including the headline grabbing one by MR Rao. He asked boards to hold managements "accountable for their actions" and take "suitable action, including replacing the management, to improve the bank's governance and risk management."

What is noteworthy in the speeches is the glossing over of the responsibilities of the directors, including shareholder directors, in the very narrow sense. There is no call to maximize profits or return money to shareholders. Reading between the lines the Governor is suggesting that board members must view themselves as Public Interest Director (PID) and not as shareholder directors.

PIDs are appointed to the board to represent the broader public interest rather than just the interests of shareholders. Their primary responsibility is to ensure that the organization operates in a manner that serves the best interests of the public.

PIDs are not new to India. They are routinely appointed on the boards of Market Infrastructure Institutions (MIIs) like stock exchanges or clearing corporations. SEBI has been recalibrating the role PIDs. The board composition of MIIs too reflects this, with the chair of an MII and the majority of directors being PIDs. Further proposals put to the board are approved only if a majority of PIDs support them. Over the years, SEBI has conflated independent directors of MIIs with PIDs.

The legal imprimatur to this shift has been provided by the Companies Act 2013. The Act prioritizes the primacy of stakeholders - employees, customers, suppliers, and communities in which businesses operate, over those of shareholders. This thinking gained more heft after the sustainable development goals or SDGs were rolled out in 2015. The SDGs linked corporate purpose with social and green objectives. Further, the various RBI circulars and court judgements including that of the Supreme Court in 2016, which interpreted the law to include officers of a private bank under the definition of a "*public servant*" as defined under Prevention of Corruption Act, 1988.

Streamlining the process of appointing independent directors in government owned banks

The current process for appointing shareholder-directors in government owned banks involves the bank inviting nominations from the public shareholders through the AGM/EGM notice. The nominations received are then scrutinized by the bank under RBIs 'Fit and proper criteria'. In case the number of candidates is more than the vacancies, the bank announces the 'approved' names through a newspaper advertisement, which is when shareholders get to vote. If the vacancies exceed or match the number of candidates, the meeting is cancelled.

The process needs change with banks first seeking nominations for shareholder-directors, through newspaper advertisements (- and not shareholder notice), and only then send the AGM/EGM notice with the names and profiles of the candidates seeking appointment. Further, even if the number of candidates equals or is less than the vacancies, they should not be automatically elected, but put to shareholders to vote in the AGM/EGM.

Clearly, the role of the bank boards has changed since the financial crisis. Today's banks need to be robust to support what will soon be a US$5 trillion plus economy. And in line with this, a bank director's judgements will need to prioritise the stability and growth of the financial system. Silently, the bank's boards have stepped into a new world of public interest directors.

A modified version of this blog was published in Business Standard on 28 June 2023. Subscribers can access the blog by clicking this link or typing the following in your url: https://www.business-standard.com/opinion/columns/the-new-world-of-public-interest-directors-123062701077_1.html

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