



INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS

Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed Edition :

www.ijlra.com

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Megha Middha, is working as an Assistant Professor of Law in Mody University of Science and Technology, Lakshmangarh, Sikar (Rajasthan). She has an experience in the teaching of almost 3 years. She has completed her graduation in BBA LL.B (H) from Amity University, Rajasthan (Gold Medalist) and did her post-graduation (LL.M in Business Laws) from NLSIU, Bengaluru. Currently, she is enrolled in a Ph.D. course in the Department of Law at Mohanlal Sukhadia University, Udaipur (Rajasthan). She wishes to excel in academics and research and contribute as much as she can to society. Through her interactions with the students, she tries to inculcate a sense of deep thinking power in her students and enlighten and guide them to the fact how they can bring a change to the society

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Mrs.S.Kalpana

Assistant professor of Law

Mrs.S.Kalpana, presently Assistant professor of Law, VelTech Rangarajan Dr. Sagunthala R & D Institute of Science and Technology, Avadi. Formerly Assistant professor of Law, Vels University in the year 2019 to 2020, Worked as Guest Faculty, Chennai Dr. Ambedkar Law College, Pudupakkam. Published one book. Published 8 Articles in various reputed Law Journals. Conducted 1 Moot court competition and participated in nearly 80 National and International seminars and webinars conducted on various subjects of Law. Did ML in Criminal Law and Criminal Justice Administration. 10 paper presentations in various National and International seminars. Attended more than 10 FDP programs. Ph.D. in Law pursuing.



Avinash Kumar



Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship. He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi. Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi. He has qualified UGC - NET examination and has been awarded ICSSR - Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

ABOUT US

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STRENGTHENING CORPORATE GOVERNANCE IN BANKS

AUTHORED BY - KHUSHI KUMARI

Introduction

Banking institutions owe high and unique fiduciary responsibility, and in light of the same, there lies a need of high accountability standards to be followed by it. India has seen many cases where poor governance in banks has resulted into various scams and banking frauds. PNB Case and Yes Bank Case are two recent ones, where poor governance in the respective banks shocked the nation. In 2018, Punjab National Bank, which is India's one of the largest public sector lenders was involved in transaction fraud case involving Rs. 11,400 crores. In this particular case, Nirav Modi while using his listed company 'Gitanjali Gems' defrauded PNB and other banks by opening letter of credits of large amounts without any underlying transactions. In doing so, few junior level banking officials were involved with him. The requirement of recording the letter of credits in the RTGS system was not fulfilled and therefore, their existence was not known. It only came to limelight after the fraud was discovered. Another incident involving the same bank was that of Mehul Choksi, where the involved amount was around Rs. 16,000 crores. As a result of the ignorance of bank management and regulators, the fraud could not be brought to attention in due time.

Another infamous case involves Yes Bank, which witnessed a sudden and unexpected fall as a result of a fraud. Rana Kapoor was the promoter of the bank with top connections. He held an important stake in making key decisions including sanctioning large loans. The bank was involved with imprudent lending practices, evergreening of loans, charging high commission not in line with industry practice to borrowers, overstatement of profits due to front loading of commission income and gross under provisioning of NPAs compared to RBI guidelines.¹ These practices resulted into the fraud, where significant differences were observed between actual and required provisioning for various years.²

¹ CA Naresh Kataria, *Corporate Frauds in India – Part I*, LAWSTREETINDIA, <http://www.lawstreetindia.com/experts/column?sid=488>.

² CA Naresh Kataria, *Corporate Frauds in India – Part I*, LAWSTREETINDIA, <http://www.lawstreetindia.com/experts/column?sid=488>.

In the fraudulent activities mentioned above, involvement of both top level and mid level employees can be seen. Therefore, it is important to strengthen all the tiers in a banking institution to ensure good governance practices. For this matter, the Reserve Bank of India (RBI) in 2020, came up with a Discussion Paper on '*Governance in Commercial Banks in India*' to improve the quality of governance in financial intermediaries, and in order to implement few aspects of the paper, a Circular was issued in 2021, which was aimed at strengthening corporate governance in banks to prevent banking frauds and hence, to keep the stakeholders' interest protected. This paper aims at analysing the RBI's Circular on '*Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*' and understanding its role in enhancing the governance standards followed by Banks in India.

RBI's Discussion Paper on '*Governance in Commercial Banks in India*'

The RBI on June 11, 2020 released a Discussion Paper on '*Governance in Commercial Banks in India*', whose objective was to align the current regulatory framework with global best practices, while keeping in mind the context of domestic financial system.³ The major highlights of the paper included – empowering board of directors to set the culture and values of the organisation, recognise and manage conflicts of interest, set the appetite for risk and manage risks within the appetite, and improve the supervisory oversight of senior management, empowering the assurance functions through various interventions, achieving clear division of responsibilities between the board and the management, and encouraging the separation of ownership from management.⁴ The discussion paper was aimed at improving the quality of governance in financial intermediaries, as it was important to determine and ensure the financial stability, protection of interest of depositors, and efficiency in allocation of resources.

RBI's Circular on '*Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*'

In order to address a few operative aspects received through the feedback on the Discussion Paper, instructions were issued by the RBI in the form of a Circular on '*Corporate Governance in Banks*

³ RBI releases Discussion Paper on '*Governance in Commercial Banks in India*', RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49937.

⁴ RBI releases Discussion Paper on '*Governance in Commercial Banks in India*', RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49937.

– *Appointment of Directors and Constitution of Committees of the Board*’ on April 26, 2021. The Circular laid down instructions with respect to the Chair and meetings of board, composition of certain committees of the Board, age, tenure and remuneration of directors, and appointment of the whole-time directors.⁵ The date from which the instructions came into effect is the date of issue of Circular itself, but banks were permitted to comply with the instructions latest by October 1, 2021 for enabling smooth transition to the revised requirements.

Applicability:

The revised instructions are applicable as follows:

1. to Private Sector Banks (including wholly owned subsidiaries of Foreign Banks and Small Finance Banks);
2. to State Bank of India and Nationalised Banks, to the extent the stipulations are consistent with provisions of specific statutes applicable to these banks or instructions issued under the statutes.

As mentioned above, the Circular has limited applicability on Nationalised Banks. It has been provided that the Circular should be read along with other relevant governing statutes, which gives the effect of it being supplementary in nature. Also, anything contained in the licensing conditions, instructions, guidelines, regulations, directions, notifications, etc., issued by RBI before the Circular, will not affect the application of the Circular.

It is not applicable in case of foreign banks operating in India through its branches. The RBI has also specified that the applicability of the Circular on other commercial banks like Regional Rural Banks, Local Areas Banks and Payment Banks will be notified separately.

Guidelines provided by the Circular:

1. **Independence of the Board:** The independence of the Board of Directors is one of the focus points of the Circular. The instructions provide for the Chair of the Board to be an independent director, so as to ensure transparency and fairness in the functioning of the Board. While emphasizing the importance of independent director, it has been provided with the responsibility of chairing the Board in absence of the Chair. The circular has clarified that the Chair of the Board, who is not an independent director, appointed before the issuance of this circular will be allowed to complete the current tenure as already approved by the RBI.

⁵ *Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*, RESERVE BANK OF INDIA, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12078&Mode=0>.

In the meetings of the Board, the prescribed quorum is one-third of the total strength of the board or three directors, whichever is higher. Also, to hold a valid meeting, the minimum strength of the independent director present shall be half of the total number of directors attending the meeting. RBI has taken a step towards protecting the interest of the stakeholders as it has increased the requirement regarding the number of independent directors to be present in the quorum in comparison to the provisions provided under the *Listing Regulations*, according to which the Board meeting of banks which are listed on Indian stock exchanges shall have the quorum of one-third of the total strength of the Board or three directors, whichever is higher, including minimum one independent director.⁶

- Audit Committee of the Board:** Audit Committees play a vital role in ensuring good corporate governance by being involved in maintaining the financial stability of any entity. Non-executive directors are essential to further this objective as they can monitor and control the actions of executive directors. The circular provides for constitution of such committee, in which only non-executive directors can be part. This keeps the interest of the stakeholders maintained as they cannot directly get influence the business decisions of banks.

In order to prevent any conflict of interest, the Chair of the Board is prohibited from becoming the member of the committee. The committee has to be chaired by an independent director, who shall not chair any other committee of the Board and shall not be member of any committee of the board which has a mandate of sanctioning credit exposures.⁷ Also, to form the minimum quorum of the meeting, for which at least three members shall be present, at least two-thirds of such present members shall be independent directors. In comparison to the guidelines provided under the *Listing Regulations*, which prescribes for the committee to meet once in every year,⁸ the instructions under the circular increase the frequency of meeting to once every quarter.

The qualification of members of such committee includes understanding of all financial

⁶ Regulation 17(2A), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-july-4-2023-_74143.html.

⁷ *Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*, RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12078&Mode=0_

⁸ Regulation 18, Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-july-4-2023-_74143.html.

statements and notes attached to it. Also, at least one member should have necessary qualification and expertise in financial management and financial accounting.

- 3. Risk Management Committee of the Board:** There is always a possibility that banking industry comes across uncertainties or threats while achieving its objectives and therefore, a risk management committee holds an important position due to the crucial role of banks in organising and regulating whole financial system. As was provided for the audit committee, the circular prescribes the constitution of risk management committee, in which majority of the members should be non-executive directors and which shall meet once in every quarter.

The minimum quorum prescribed is three members and at least half of the members present in the meeting shall be independent directors, out of which at least one member shall have professional qualification and expertise in risk management.⁹ Also, the qualification prescribed for a Chair is to be an independent director, not a Chair of the board and not a Chair of any other committee of the board. An exception is provided for a Chair of the board to be Chair of the risk management committee, when such member has necessary expertise in risk management.

- 4. Nomination and Remuneration Committee:** This is another important committee for corporate governance as it aims to ensure that the executive compensation offered is competitive, fair and aligned to the goal of the organisation. This further ensures that the reward policy adopted by the board is appropriate and motivates executives to protect the interest of shareholders through long-term perspective. Similar to the committees mentioned above, this committee has to be constituted with only non-executive directors, it shall meet with a quorum of three members, at least half of attending members shall be independent directors, meetings shall be chaired by independent director and the chair of board shall not be a chair of this committee.¹⁰

Also, one of the attending members in a meeting of nomination and remuneration committee shall be member of risk management committee. There is no frequency defined for the meetings of this committee, as the circular mentions that it shall meet as and when required.

⁹ *Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*, RESERVE BANK OF INDIA, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12078&Mode=0>.

¹⁰ *Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*, RESERVE BANK OF INDIA, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12078&Mode=0>.

5. **Age and Tenure of Non-Executive Directors:** In comparison to the guidelines provided under the *Listing Regulations*, where in a listed company, a person can only be appointed or can continue to hold the position of non-executive director after attaining the age of seventy-five years, if a special resolution justifying the reason for such appointment is passed,¹¹ the instructions under the circular increases the upper age limit of non-executive directors by ten years and prohibits any reappointment or continuation of tenure. It provides that after the person appointed as non-executive director, including Chair of the board, attains the age of seventy-five years, they cannot continue to hold their positions.

The maximum period for which a person can remain a non-executive director on the board of bank in any case is prescribed to be eight years. A cooling period has been provided under the instructions for this matter, which is three years. Therefore, a person can be re-appointed to the board only after a minimum gap of three years has elapsed after the end of term of eight years. The circular does not obstruct the person to be appointed as director in another bank and therefore, he/she can be appointed in another bank if fulfils the requirements.

6. **Remuneration of Non-Executive Directors:** In order to attract and encourage the non-executive directors to serve in the board, the circular has tried to increase the forms in which compensation can be awarded to them. Prior to the circular, non-executive directors were only provided with sitting fees and expenses related to attending meeting of the board and its committees, but now, a bank can offer them a fixed remuneration commensurate. The maximum amount of compensation in form of fixed remuneration that can be provided to a non-executive director, other than the Chair of the board, is twenty lakh rupees per annum.
7. **Tenure of Managing Director & Chief Executive Officer and Whole Time Directors:** As compared to the guidelines prescribed under the *Banking Regulation Act, 1949*, the circular has increased the tenure of the Managing Director & CEO or Whole Time Director from five years at a time with reappointment criteria of another five year after a cooling period of two years, to a maximum period of fifteen years with reappointment criteria if considered desirable and necessary by the board after a cooling period of three years. Additionally, the instructions

¹¹ Souvik Ganguly, Saumya Sharma and Altamash Qureshi, *RBI Pushes For Massive Governance Reforms Of Banks In The Aftermath Of Recurring Bank Frauds*, *MONDAQ*, <https://www.mondaq.com/india/corporate-governance/1093700/rbi-pushes-for-massive-governance-reforms-of-banks-in-the-aftermath-of-recurring-bank-frauds#:~:text=On%2026%20April%202021%2C%20RBI,the%20banking%20sector%20in%20India.>

provides that during the three years cooling period, the individual cannot be associated or appointed with the bank or its group entities in any capacity, either directly or indirectly.¹²

RBI has further clarified in relation to private sector banks that the Managing Director & CEO and Whole Time Directors cannot continue to hold their positions beyond the age of 70 years. Also, a lower retirement age can be prescribed by the board of a bank as a part of their internal policy.

In case where a Managing Director & CEO or Whole Time Director is also a promoter or major shareholder, the maximum tenure prescribed is 12 years, where they can be allowed to continue up to 15 years at sole discretion of the RBI in extraordinary circumstances. For this matter, the RBI shall consider factors like adherence to the milestone for dilution of shareholding of the promoters in the bank and the level of progress thereof. Lastly, where the tenure of the Managing Director & CEO or Whole Time Director has already been completed till twelve or fifteen years on the date of issuance of the Circular, and has been further extended, they will be allowed to complete the remainder of their current term.¹³

Conclusion

The Circular on '*Corporate Governance – Appointment of Directors and Constitution of Committees of Board*' has tried to separate management from ownership, which has been the intention of RBI all along. This is because, where management and ownership do not interfere with one another's jurisdiction, best interest of bank is maintained and it ensures unbiased or uninfluenced decisions. The Circular includes adequate instructions in order to equip the Board with relevant skills, knowledge and experience.

The Circular has focused on the role of Independent Directors in the Board so as to improve corporate accountability and credibility. The power of the Board has been effectively decentralised through the requirement of constituting Committees, which will be vital in providing effective and necessary support to it while improving the quality of management and preventing any one-sided decisions. It has also been ensured that the Board gets deeply involved into risk oversight, which

¹² *Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board*, RESERVE BANK OF INDIA, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12078&Mode=0>.

¹³ Souvik Ganguly, Saumya Sharma and Altamash Qureshi, *RBI Pushes For Massive Governance Reforms Of Banks In The Aftermath Of Recurring Bank Frauds*, MONDAQ, <https://www.mondaq.com/india/corporate-governance/1093700/rbi-pushes-for-massive-governance-reforms-of-banks-in-the-aftermath-of-recurring-bank-frauds#:~:text=On%2026%20April%202021%2C%20RBI,the%20banking%20sector%20in%20India>.

will help the Board in monitoring the risks by understanding them.

Separation between the Committees is maintained by providing for different chairmanship in each one of them in order to avoid any interference by one another. The Circular sufficiently prescribes the terms of managing directors and directors of banks to prevent governance issues and to enable involvement of new talents into the board. Therefore, by analysing the Circular, it can be stated that the instructions provided therein has tried to enhance the governance standards in India for Banks to de-rail any future banking frauds and scams and safeguarding the interest of stakeholders.

