Building effective banking governance

Moving beyond the "what" and "how" of governance

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The recent RBI discussion paper contains a number of proposals on improving governance in commercial banks. However, they suffer from a common organisational fallacy that if structures and systems – the hardware – are spelled out, everything else will fall in place, and good governance will automatically happen. The paper emphasises the "what" and "how" of governance by stating broad responsibilities and structure, but there is a need to strengthen the "who" and soft aspects of governance further.

The decision to cap the maximum tenure of promoter/major shareholder as CEO/WTD to 10 years is a welcome step. A long – and uncapped – tenure raises the risk concentration of power and decision-making. It leads to hero-worship and dependency on the CEO. The recent example of Yes Bank shows these dangers. For more than a decade, Yes Bank was one of the leading private banks and boasted of many achievements. Yet, its fall was dramatic and surprising, and required urgent intervention from the RBI and government.

The unfortunate reality is that Yes Bank was not the only example, particularly if we include less extreme CEO failures. Both internationally and nationally, there were banking CEOs, who were celebrated and hero-worshipped, but later lost their status once their failure became known. Perhaps, an important pay-off from the tenure cap is behavioural: The CEOs may be forced to confront the "mortality" of their positional power and that alone could influence them to act differently. This is important, as banks are complex businesses, which are also known to be accident prone with contagion effects on the economy.

The "who" question also arises in the context of other board members. While the proposals require relevant qualifications and experience, this by itself may not lead to an accountable board. Effective governance requires members who are active and raise challenges. There is a need to select members after extensive due diligence that involves review of their antecedents, track-record and contributions. Regulators could make it mandatory that the NEDs are selected from names recommended by regulator/SEBI, which could maintain a panel of board members, their roles and key contributions on strategic matters during their various stints. This would also provide intangible incentive to board members, who had played an active role in their previous board roles. Banks can specify their requirements to SEBI/regulators, and receive few recommendations from which NRC could select a member. Similarly, NRC could do more due diligence in case of Public Sector Banks (PSBs), except for government and RBI directors.

Research indicates that corporate governance innovations have a dismal record. Ineffective governance is a self-sustaining disorder – that survives on indifference and lack of ownership. In reality, it is influenced by soft processes, such as social dynamics, group expectations, influence of authority figure, norms on challenging each other, etc. Research shows that group effectiveness suffers when there is lack of skin in the game, groupthink, strong authority figure, and lack of psychological safety. The board chair must ensure a "skin in the game" through extensive documentation of contributions from various members into the decisions made. To develop true accountability, the board should track the deliberations, contributions and consequences of the decisions made. Similarly, there is a need to discourage passive, or non-contributory, membership by developing informal norms and formal review processes that should be referenced when members are recommended for another board membership. Attention to such "optional" and "extra" soft processes could be the difference between effective and bureaucratic boards.

The board chair could also outline "soft standards" or informal norms to improve governance. This will include seeking different views, building diversity, expectations that each member should have a view, if not a stand, and willing to be noted for that, develop mechanisms to limit influence of authority and charisma, devote most time to strategic priorities, incorporate best practices regularly, encourage discussions on leadership issues, etc.

There is a need for overarching support from regulators, government, and research institutes to build effective boards. The government could reform and simplify the governance in PSBs and provide a psychological safety, lack of which currently stymies the decision-making process. PSBs will also benefit if the ambiguities in the governance frameworks between the RBI and government are addressed.

Well known management scholar, Jim Collins, noted that good to great leaders first pay attention to "who" and then to "what", or in other words they first got the "right people on the bus, the wrong people off the bus, and the right people in the right seats – and then they figured where to drive it". The RBI discussion paper does not contain much to address this. ◆

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