Banks Board Bureau

Compendium of recommendations

March 2018

Contents

Foreword

After nearly three decades of liberalisation and with nearly 70% of the banking intermediation business still being transacted through public sector banks (PSBs), bringing in enduring efficiency in allocation of savings and capital continues to be a challenge.

Reforms in the public sector banking system have been suggested by various committees in the past, beginning with the Narasimham committee in 1991. In the wake of Dr P J Nayak committee recommendations of May 2014, the setting up of the Banks Board Bureau (the Bureau) with specialised expertise in the area of banking and governance was a novel experiment and a step in the right direction by the Government.

While the government retains its majority shareholding, it is very much possible for the public sector to reach the same levels of efficiency, as the private sector, provided governance regulations, supervision and the developmental agenda are allowed to be ownership neutral.

In the journey to achieve a governance structure in PSBs that will be relevant for a new India, it is unrealistic to expect that nearly half a century old systems and processes, set up in the wake of nationalisation of banks, can be undone overnight. There is also a need to remove scepticism to the view that PSBs can indeed be run in the tax-payers interest with the goal of generating enduring financial returns that can be deployed towards more pressing budgetary demands.

After all, it is for all those few who are associated with the PSB ecosystem to align their interests with the interests of the remaining large and silent majority. Not doing so would mean further acceleration of the process of loss of market share, compromise of processes, weakened internal capital generation ability and increased dependency on the resources of the tax payer.

Guided by these thoughts and a spirit of collaboration, the Bureau, a public authority with only a recommendatory role, has been engaging with various stakeholders in fulfilling its mandate after detailed deliberations.

The Bureau will soon be completing two years of its being. Accordingly, this compilation of the Bureau's various recommendations is an effort to encourage a more informed debate on the recommendations made by the Bureau in the context of the institutional perimeter given to it. The compilation also reflects on the role of the Bureau, going forward. In order to maintain the reader's interest, the compilation is not entirely a verbatim repetition of the recommendations.

While releasing this compilation, I would like to take the opportunity to thank my colleagues at the Bureau, both past and present for the timeless contributions to this important crusade, despite many odds.

I would also like to acknowledge the role played by the Reserve Bank of India in making available to the Bureau, at a very short notice, all the required resources for the smooth functioning of the Bureau.

The Indian Banks' Association and the Public Sector Banks also deserve a special mention for making it possible for the Bureau to overcome certain operating challenges. Last but not the least, I would like to thank various stakeholders who engaged with the Bureau and provided valuable insights.

My best wishes to all who are passionately awaiting a vibrant, resilient and ethically strong public sector banking system in India.

Vinod Rai

Chairman
Banks Board Bureau

March 19, 2018

Overview

This compilation is divided into various chapters. Each chapter is based on a specific mandate of the Bureau. Since the challenges faced by the PSBs have been widely recognised, each chapter of this compilation is limited to listing the inventory of recommendations made by the Bureau on each mandate[1]. Some contents in this compilation is a reflection of the view of the Bureau or the nature of the work in progress.

2. The Banks Board Bureau came into being on April 01, 2016. Details on evolution of the Banks Board Bureau and the extant mandate of the Bureau is provided in **Chapter – I**.

3. Immediately on commencement, the Bureau gave priority to ensure appointments of wholetime Directors are completed before the existing incumbent's tenure ends. **Chapter –II** of this compilation offers details of the recommendations made by the Bureau on its mandate relating to appointments.

4. After having completed its mandate regarding appointments, Bureau covered its other mandates resulting in various recommendations under the overarching theme of **Governance, Reward and Accountability Framework (GRAF)** within PSBs. **Chapters –III, IV, V & VI** offers details of the recommendations made by the Bureau under this theme. The Bureau's recommendations on **GRAF**, if implemented, is expected to *interalia* provide the right incentives to mitigate the risk of recurrence of episodes of risk taking beyond capacity in good times and extreme risk aversion during bad times.

5. The Bureau's view on various other mandates such as **strategy**, **capital** and **human resources in PSBs** is articulated in **Chapter-VII, VIII & IX** respectively.

6. What could be the future role of the Bureau? The outcome of this introspection undertaken by the Bureau is provided in **Chapter –X**.

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[1] Regardless of the risk of being too prescriptive or repetitive, the recommendations of the Bureau on formulation and enforcement of a code of conduct and ethics in PSBs which were made in March 2017, have been reproduced in this compilation in its entirety considering the immediate nature of the challenge before the nation and the need to ensure swift implementation.

Chapter –I

Mandate

The Banks Board Bureau owes its genesis to the recommendations in the *Report of The Committee set up by the Reserve Bank of India to Review Governance of Boards of Banks in India* (Chair: Dr P J Nayak; May 2014), which envisaged the Bureau as a precursor to a Company which would eventually hold the Government's investments in PSBs.

2. The first public recognition by the Government of this concept of forming the Bureau appeared in the Union Finance Ministers' Budget Speech of February 2015 (Para 81),

> ***"In order to improve the Governance of Public Sector banks, the Government intends to set up an autonomous Bank Board Bureau. The Bureau will search and select heads of Public Sector banks and help them in developing differentiated strategies and capital raising plans through innovative financial methods and instruments. This would be an interim step towards establishing a holding and investment Company for Banks."***

3. Following up on the FM's speech, the Government's Press Note of August 15, 2015, issued after the first Gyan Sangam held in Pune, articulated the role and composition of the Bureau in the following terms:

> ***"The announcement of the Bank Board Bureau was made by Hon'ble Finance Minister in his Budget Speech for the year 2015-16. … will be a body of eminent professionals and officials, which will replace the Appointments Board for appointment of Whole-time Directors as well as non-Executive Chairman of PSBs. They will also constantly engage with the Board of Directors of all the PSBs to formulate appropriate strategies for their growth and development. …. will comprise of a Chairman and six more members of which three will be officials and three experts (of which two would necessarily be from the banking sector). The Search Committee for members …. would comprise of the Governor, RBI and Secretary (FS) and Secretary (DoPT) as members."***

4. Subsequently, on April 01, 2016, the Bureau came into being as part of the Nationalized Banks (Management and Miscellaneous Provisions) Amendment Scheme 2016, under section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/ 1980 notified through publication in the Gazette of India on March 28, 2016.

5. At the inaugural meeting of the Bureau which was addressed by Mr Jayant Sinha, the then Minister of State for Finance and Dr Raghuram Rajan, the then Governor, Reserve Bank of India, on April 08, 2016 the following views emerged *interalia*:

i. The extant terms of reference to the Bureau were nebulous. The Bureau had a space to occupy and it had to itself define the space it would like to cover over a period of next two years.
ii. In the case of appointments, the role of the Bureau was limited to wholetime Directors and non-executive Chairman of PSBs. In order to ensure effective corporate governance through professionalisation of Boards of PSBs, it was necessary to broaden the Bureau's role to include non-executive Directors.
iii. To ensure that appointments at Board levels were accelerated while filling in existing and future vacancies, the recommendations made by the Bureau should directly be forwarded to the Appointments Committee of the Cabinet (ACC). This was more so when both the Secretary, Department of Financial Services (DFS) and Deputy Governor, Reserve Bank of India (RBI) being members of the Bureau and part of the appointment process.
iv. Stressed asset resolution was the most important challenge facing PSBs and a concerted and co-ordinated effort towards recovery became a priority area where the Bureau should have a role to play.

6. Accordingly, it was decided that the Bureau should set for itself a revised 'Terms of Reference' and submit the same to the Ministry of Finance for finalisation. Bureau's recommendations on revised terms of reference were sent to the DFS in May 2016.

7. However, in a response received from the DFS in November 2016 the following mandates sought by the Bureau were not accepted:

i. Recommendations be placed directly before the ACC.

ii. Search and selection of Non-official Directors on PSB Boards.
iii. To develop a roadmap for transition of the Government share-holding into a Bank Holding Company.
iv. A specific mandate on Stressed Asset Resolution Strategies.

8. Therefore, based on the notification published in the Gazette of India, and subsequent communication received from the DFS, the current mandate of the Bureau is as follows:

a) to recommend the selection and appointment of wholetime Directors(WTDs);
b) to recommend the selection and appointment of non-executive Chairmen(NEC);
c) to advise the Central Government on matters relating to appointments;
d) to develop an appropriate methodology to enable the search and selection of high calibre wholetime Directors of PSBs;
e) to advise the Central Government on matters relating to confirmation or extension of tenure and termination of services of the Directors;
f) to advise the Central Government on the desired management structure at the level of Board of Directors, and, for senior management;
g) to advise the Central Government on the formulation and enforcement of a code of conduct and ethics;
h) to help banks to develop a robust leadership succession plan for critical positions that would arise in future through appropriate HR processes, including performance management systems;
i) to advise the Central Government on evolving suitable training and development programmes for management personnel in PSBs;
j) to build a data bank containing data relating to the performance of PSBs and share the same with Central Government;
k) to build a data bank containing data relating to the performance of senior management and the Board of Directors and share the same with Central Government;
l) to help the banks in terms of developing business strategies and capital raising plan and the like; and
m) any other work assigned by the Government in consultation with Reserve Bank of India.

Chapter -II

Appointments

The Bureau's mandate with reference to appointments is as follows:

i. to recommend the selection and appointment of wholetime Directors;
ii. to recommend the selection and appointment of non-executive Chairman;
iii. to advise the Central Government on matters relating to appointments;
iv. to develop an appropriate methodology to enable the search and selection of high calibre wholetime Directors of PSBs;

2. To ensure succession planning, top priority has been accorded by the Bureau to appoint successors to the incumbent wholetime Directors. However, this process can be initiated by the Bureau only after the DFS makes available to the Bureau the list of personages and vacancies to be considered for appointments.

3. Recognising the delays in the extant process, the DFS was requested to initiate the process well in advance so that the pool of eligible personages with necessary clearances was made available *apriori*.

4. While some progress has been achieved in reducing the time lag in appointments, instances of vacancies of wholetime Directors continue to persist, despite the Bureau making its recommendations well in advance.

5. In case of appointments of wholetime Directors, the Bureau recognised the need to encourage succession from within the same organisation to ensure continuity and accountability. Therefore, it was recommended that at least one Executive Director should be from within the organisation who should have exclusive oversight over the non-revenue generating functions of the PSB so as to enhance the vigil on internal controls and risk management.

6. For the remaining vacancies of Executive Directors as also the MD& CEO openings, applicants from outside the PSB universe should be allowed to compete with the existing pool of talent from within the PSB universe, just as talent from outside were allowed to compete for MD & CEO openings in five large PSBs and are already allowed to compete for such openings in Central Public Sector Enterprises.

7. For the appointment of non-executive Chairmen (NEC) in PSBs, there has been only a limited success. Significant challenge remains as reflected in the existing vacancies of not just the non-executive Chairman but also that of other non – executive / non-official directors. Anticipating this and in order to attract quality personages for these positions which are facing a much higher magnitude of challenges than most private sector peers, the Bureau made the following recommendations:

i. When it comes to attracting personages on Boards, PSBs should not be adversly positioned vis-a-vis the private sector. The government should make the extant guidelines on eligibility of personages for appointment on Boards of banks, ownership neutral.

ii. While professionalising Boards of PSBs, it would be pragmatic to put in place a mechanism to recognise what constitutes "conflict of interest" and manage these conflicts within the operating perimeter of existing statutes /regulations.

iii. Competencies in the areas of Risk Management, Information Technology and Human Resource Management are missing on the Boards of most PSBs. To address this, the Boards of PSBs through its Nomination Committee should be allowed to recommend personages having requisite qualifications, attributes and independence within the extant instructions on ''fit and proper'' criteria.

iv. In matters related to remuneration and service conditions for the part-time/non-executive Directors, including NECs, as has already been done in the case of Central Public Sector Enterprises (CPSEs), Board of PSBs be unambiguously allowed the powers on the same lines as prescribed under the SEBI(LODR) Regulations, 2015 and/or Companies Act, 2013.

8. The Bureau continues to await latest updates from the DFS on the status of these recommendations. Most of these recommendations were made a year ago.

Chapter -III

Compensation[2]

Compensation practices are an essential component of governance reforms. A comprehensive reform in compensation practices in PSBs would be one of the necessary steps to ensure that interests of internal stakeholder's viz., management and employees, are aligned to interests of external stakeholder's viz., customers, tax payers and other shareholders.

2**.** In the public sector, Government has already allowed enterprises to have compensation system which includes compensation based on performance. Mindful of the asymmetry within the public sector and to align the interest of various stakeholders, the following recommendations were made:

i. Since PSBs operate in the same sector, the design of compensation based on performance should be similar across all PSBs. This will ensure consistency in adoption and at the same time ensure differentiation in compensation based on performance and paying capacity of each PSB.
ii. Unlike civil services, PSBs operate in a competitive space. Accordingly, compensation of employees of PSBs should be delinked from the compensation of civil services.
iii. Introduction of performance based compensation should be possible only for those employees above a certain level for whom a PSB chooses not to be part of the extant industry wide compensation determining process.
iv. For such employees, compensation should be made up of a fixed component and a variable component – both short term and long term.
v. The short term variable component should be in the form of Performance Linked Incentives (PLIs) which should initially be restricted to not more than 50% of fixed component.
vi. The long term variable component should be in the form of Employee Stock Options (ESOs).

[2] The Department of Financial Services, Ministry of Finance, and Government of India had sought the Banks Board Bureau's advice on Employee Stock Options in PSBs.

vii. To qualify for PLIs and ESOs in a year, the Bureau has suggested the following performance tolerance thresholds which are agnostic to size, scale and scope of the business of PSBs:

   a. A return on asset to reward internal capital generation.
   b. A provision cover to maximise inherent strength to absorb expected losses.
   c. A proportion of networth[3], to ensure adequate capital for unexpected losses.
   d. A proportion of stressed assets, to maximise responsible credit underwriting[4].

viii. In order to be mindful of the cost considerations, operating profit margin should continue to remain above a pre-determined threshold even after factoring in the expenditure on account of variable compensation.

ix. The total pool of PLIs available to a PSB should be limited to 5% of its profit before tax for the year.

x. The number of ESOs to be granted in any year should not be more than 0.75% of the total paid up capital of the PSB.

xi. In order to harmonise the difference in paid up capital across PSBs, an "equalisation factor" should be applied. This will ensure that for the same degree of appreciation in share price of two or more PSBs the ESO benefits that would accrue would be the same.

xii. Number of ESOs granted to an MD& CEO (equivalent) in a year should be less than 5% of the total options granted in a year.

xiii. The PLIs and ESOs to be awarded/granted to each employee should be based on (a) relative performance of a PSB *vis–a-vis* the performance of other PSBs, (b) level of responsibility of the employee and (c) performance of an employee against Key Performance Indicators (KPIs) set for the cohort.

xiv. Employees engaged in non-revenue generating functions should be compensated in a manner that is independent of the revenue generating functions that they

[3] After factoring non-performing assets not fully provided for.
[4] To mitigate recurrence of high asset impairments.

oversee/engage with.[5] Their KPIs should be uniquely designed for the functions they perform and should be bereft of any revenue generating indicators.

xv. The available PLIs and ESOs pool should be carved out separately in proportion to the number of employees who are manning the non-revenue generating functions in the respective PSB.

xvi. Each year's PLIs / ESOs to be disbursed /vested across years so that compensation pay-outs are sensitive to time horizon of risks.

xvii. Compensation to be subjected to malus/clawback arrangements[6].

xviii. A combined Nomination and Remuneration Committee (NRC)[7] of the Board should be allowed to oversee framing, implementation and review of compensation policy covering all employees and all aspects of compensation. NRC should have a minimum of three members, majority of independent members and include at least one member from Risk Management Committee (RMC) of the Board. It should work in close coordination with RMC to achieve effective alignment between remuneration and risks.

3. These recommendations were made by the Bureau on January 31, 2017. The Bureau awaits latest updates from the DFS on the status of these recommendations.

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[5]Employees in the non-revenue generating functions play a key role in ensuring the integrity of revenue generating functions. If their own compensation is importantly affected by short-term measures, their independence could be compromised.

[6] A malus arrangement permits the bank to prevent vesting of all or part of the amount of a deferred remuneration. Malus arrangement does not reverse vesting after it has already occurred. A claw back, on the other hand, is a contractual agreement between the employee and the bank in which the employee agrees to return previously paid or vested remuneration to the bank under certain circumstances.

[7] Presently, in PSBs there are two separate committees – one is the Nomination Committee and the other is the Remuneration Committee.

Chapter -IV

Performance Assessment[8]

Once the new compensation philosophy is adopted, the process of empowering PSBs to operate on commercial lines should be rolled out in tandem with the process of encouraging a culture of discerning performance. This can be done within the present institutional capacity and without any additional governance architecture.

2. It is possible to do so through a **Relative Performance Rating (RPR) framework.** Under this framework the Bureau has made the following recommendations:

i. Rating/Ranking of each PSB to be based on their performance relative to other PSBs as indicated below:

S No	Rating	% of PSBs in each rating scale
1	Relatively outstanding	(Top 10% of the PSBs)
2	Relatively above average	(Next 25% of the PSBs)
3	Relatively average	(Next 25% of the PSBs)
4	Relatively below average	(Next 30% of the PSBs)
5	Relatively poor	(Next 10% of the PSBs)

ii. Rating/ranking of PSBs to be based on each PSBs performance in relation to other PSBs during a period as well as between two consecutive periods with a bias to pick adverse trends early so as to prompt a PSB to adopt a corrective strategy.

iii. Rating/ranking to be based on Key Performance Indicators (KPIs).

iv. The choice of KPIs to be based on following principles:

  a. Universally applicable across banks irrespective of ownership.
  b. Uniformly applicable irrespective of size, scale and scope of business.
  c. Stand the test of time and all phases of a business cycle.
  d. Minimal, easily monitorable and bereft of subjectivity.

[8] The Department of Financial Services, Ministry of Finance, Government of India had sought the Banks Board Bureau's advice on the matter, in addition to the mandate of the Bureau on appropriate HR processes including performance management systems

v. Accordingly, the following indicators, with equal weightages to begin with, have been recommended:
   a. **Return**: Return on average assets[9]
   b. **Asset Quality**: Stressed Assets (net of provisions) to Total Assets[10]
   c. **Risk**: Risk Weighted Assets to Total Assets[11]
   d. **Cost**: Cost to Income[12]

vi. Once the RPR of a PSB is arrived at, it should be used to arrive at the performance assessment of employees of the PSB.

vii. To ensure individual performance is reasonably well aligned to the performance of the PSB, the individual performance of employees at higher responsibilities to be increasingly linked to the performance of the PSB.

viii. This linkage would also facilitate decision making for extending the tenure/ reappointment/ termination of an incumbent Director.

ix. The linkage with individual performance would also facilitate arriving at the decision on the quantum of variable compensation to be awarded to employees.

x. Standardisation has been recommended in order to ensure comparability across PSBs.

3. Ideally, setting of KPIs should entirely be driven by the Board of Directors. However, considering the majority shareholder being common across all PSBs, it becomes imperative that a common template be developed across all PSBs for setting the expectation of the major shareholder as well as for making it possible to compare the performance of each and every PSB relative to other PSBs. This could also ensure the common goal of working towards improving the overall performance of the PSBs.

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[9] A financial efficiency indicator which is the result of the strategy followed by the bank in managing its balance sheet and, unlike Return on Equity, is independent of the capital structure.

[10] This indicator is not just limited to NPAs but also includes other forms of stressed assets i.e., Net Non-performing Assets+ SMA-2 + Std Restructured Assets + Security Receipts+ Std Assets under SDR, Std Assets under 5/25 + Standard Assets under S4A+NCLT cases. This should nudge the PSBs towards early recognition and adoption of resolution strategies as also encouraging PSBs to make adequate provisions to ward of repeat of the present problems.

[11] A reasonable proxy indicator to indicate the level of risk borne by a bank to earn its return; a better indicator than CRAR considering PSBs reliance on capital infusion from the GoI.

[12] Indicates efficiency of the PSB to manage its operating expenses

4. The Bureau firmly believes that this template would provide requisite information to the Board to professionally and sceptically challenge the management. Further, the Board of Directors would have the leeway to set its own targets for each of these KPIs, set individual targets for various components of each KPI and also assign targets to the wholetime Directors as well as some of the key management personal.

5. The relative performance of a PSB would depend on initiatives taken including on matters related to technology, human resources and public policy. Such initiatives are means to improve the overall performance of PSBs and is not an end in itself. Considering the history of capital infusion by the Government in PSBs, the focus of the RPR framework is on PSBs ability to generate internal capital in a sustainable manner. It is this ability to generate internal capital which would help PSBs diversify its shareholder base, reduce dependency on the tax payer/Government and eventually enhance Government's budgetary resources.

6. These recommendations were made by the Bureau on February 22, 2017. The Bureau awaits latest updates from the DFS on the status of these recommendations. Regardless of this, the Bureau has taken the initiative of undertaking the Relative Performance Rating of PSBs and transmitting the same to the Government from time to time to facilitate decision making regarding the extension/termination of incumbent WTDs.

Chapter -V

Governance Reforms

One of the mandates given to the Bureau is to advise the Government on the desired structure at the Board level and for senior management personnel for each PSB. Further, the Government had requested the Bureau to deliberate on measures that could be considered to strengthen Board governance.

2. Accordingly, to begin with, the Bureau has made recommendations with an intent of setting a standard operating environment on governance in PSBs[13]. These recommendations were made with the objective that governance standards within PSBs should be allowed to have the capacity to lean against the risk of behest-lending and to reduce the moral hazard from implicit sovereign guarantee. Lack of a standard operating environment will risk the recurrence of amplified business cycles. This in turn would continue to result in increased credit costs during adverse phase of the cycle in lieu of lower credit costs during favourable part of business cycles.

3. Mindful of this context, the Bureau has made its recommendations on governance reforms. These recommendations are a sequel to the various recommendations made, details of which have been provided in previous chapters.

4. In the nearly five decades since nationalisation on banks, prescriptions on governance standards in the country have markedly improved. However, these prescriptions are yet to make inroads into the PSB ecosystem. In recognition of this, it was recommended that the swiftest way to usher in governance reforms in nationalised banks, while retaining Government shareholding at above 51%, is to insert a provision in the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80 to state that wherever the provisions of the Act are inconsistent with the provisions of Companies Act, 2013, the provisions in the Act would not be applicable, provided there is no inconsistency with any provisions of the Banking Regulation Act 1949, in which case the provisions of BR Act, 1949 should be applicable.

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[13] The State Bank of India has its own statute and IDBI is a banking company under the Companies Act. Amendments in the Articles of Association of IDBI Bank should be considered to align with the recommendations made here.

5. Alternatively, and specifically, the following recommendations were also made:

i. The non-executive Directors nominated/appointed by the Government on PSB Boards may not fulfil the criteria of Independent Directors[14]. Nevertheless, these non-executive directors be empowered to perform the role of Independent Directors.

ii. The Board of PSBs be empowered to set up its Nomination and Remuneration committee (NRC), which currently exists as two separate committees, mirroring in its composition and mandate the relevant provisions in the Companies Act, 2013/ SEBI(LODR) Regulations, 2015.

iii. The NRC should put in place a Board diversity policy to ensure that the committees of the Board would not be dominated by any one individual or small group of individuals. It should also undertake a review of the manning of the committees of the Board to ensure adherence to the same. NRC should be empowered to recommend to the Board the constitution / reconstitution of any committee of the Board to ensure that the constitution is in accordance with guidelines which are ownership neutral and there is rotation of members on the committees.

iv. Despite common regulators and a common major shareholder, there is wide variation in number of committees of the Boards across PSBs. There is no unequivocal evidence to prove that more the committees of the Board, the better the oversight of the Board and therefore, the better the performance of the PSB. Some of the relatively better performing PSBs have just the same number of committees of the Board as is the case with private sector banks. Accordingly, recognising that there are legacy issues from the past, there is a need to rationalise the number, composition and mandate of the committees of the Board.

v. While the constitution of the committees is in the domain of the Board, in the interest of best practices of corporate governance, the NRC to recommend to the Board:

[14] As per Section 178 of the Companies Act, 2013 & Regulation 19 of the SEBI (LODR) Regulations, 2015.

a. committees to be chaired by a non-executive/independent director

b. committees to be predominantly comprised of non-executive directors/independent directors, except in the case of those committees which are pursuing the management function of the Board.

vi. To enhance the ability to assess the performance of the Directors, the Boards of PSBs to be empowered to undertake necessary activities on the lines of the provisions of the Companies Act, 2013.

vii. The tenure, reappointment and cooling off period of a non-executive Director to be aligned with the extant BR Act/ Companies Act provisions. During the cooling off period, a non-executive Director should not be appointed on the Board of any other PSB.

viii. Leadership is not a trait in abundance. It needs to be encouraged, groomed and retained. In private sector banks, a wholetime Director can continue till the age of 70. The Bureau has therefore recommended that the tenure of an MD & CEO of a PSB be fixed for at least a three year period without being constrained by the extant age of superannuation but subject to performance evaluation for continuation, extension or re-appointment.

ix. At present, the number of employees in a PSB is based on a prescribed formula centred on the total business of the PSB viz., total advances and deposits. Such prescriptions leads to perverse incentives to build balance sheet size at the cost of building attendant risks which manifests later. To mitigate this, the Bureau has recommended that Boards of PSBs be empowered to decide the organisation structure and deployment depending upon needs and strategy of each PSB.

x. Currently, credit underwriting decisions for large borrowers is undertaken by Management Committee of the Board (MCB). The MCB includes non-executive Directors. However, the recent episode of stressed asset build-up makes it evident, in varying degrees, that PSBs have not derived full benefit from the collective experience, insight and diverse exposure that non-executive Directors were thought to bring to bear while taking credit underwriting decisions for large borrowers. Therefore, it cannot be stated with certainty that the participation of non-executive Directors for underwriting large value proposals would fulfil the spirit of good governance. Rather, it could be argued that presence of non-executive Directors on the MCB would dilute their ability to exercise supervisory oversight on the management function of the Board. In this context, the following recommendations have been made by the Bureau:

   a. The MCB be reconstituted with only WTDs who would undertake the management function of the Board. The MCB be delegated any other functions which would not be in the form of supervisory functions of the Board.
   b. The Risk Management Committee (RMC) of the Board be given the mandate to decide on the credit rating and credit exposure threshold matrix within which the MCB as well as various executive committees/individuals to undertake various credit underwriting decisions.
   c. The Credit Approval Committee of the Board to be dispensed with.
   d. The minutes of the meetings of the MCB to be placed before the RMC as well as the Board so that the latter two can exercise the supervisory function.

xi. The ability of the financial reporting process to accurately recognise the level of impairment of assets as well as outside liabilities, is being increasingly challenged. This has *interalia* called into question the role and responsibility of the Audit Committee of the Board (ACB). To restore the credibility of the ACB, the following recommendations have been made by the Bureau:

   a. The Boards of PSBs be empowered to set up its Audit Committee mirroring in its composition and mandate the relevant provisions of the

Companies Act, 2013 / SEBI (LODR) Regulations, 2015 as well as the RBI guidelines.

b. ACBs be given explicit/overarching /core mandate to oversee financial reporting process and disclosure of financial information to ensure that financial statements are correct, sufficient and credible.
c. WTDs should not be part of the ACB. However, ACB may choose to interact with WTDs as and when necessary.
d. The director nominated by the Government under the 'Charter Accountant Director' provision should be a member of the ACB.
e. The members of the ACB to elect the Chairperson.
f. The Head of Internal Audit Function (third line of defence) to have direct reporting to the ACB.
g. In addition to the calendar of reviews mandated by RBI, the reviews required under the SEBI (LODR) Regulations, 2015 to be explicitly included in the mandate of the Audit Committee of the Board.

6. These recommendations were made by the Bureau on March 15, 2017. The Bureau awaits latest updates from the DFS on the status of these recommendations.

Chapter -VI

Code of conduct and ethics[15]: formulation and enforcement[16]

Conduct and ethics determines the culture of an organisation. Culture is driven by those at the top of the organisation by setting standards of personal conduct. Culture influences the day-to-day decisions of management and employees. Culture is a key determinant of the risk assumed. There is a need to have governance ecosystems that ensure the right culture to help build credible institutions.

2. A culture of misconduct is normally associated with wilful disregard of laws, regulations and governance policies/processes/procedures. It is more likely to be prevalent in those organisations where internal processes and governance are inadequate. One could argue that prescriptions on ethics and conduct does not really matter. However, it has come to be accepted that pragmatic and pro-active organisations do recognise that reinforcing the right conduct and behaviour would require commandments to be set and followed steadfastly.

3. Mindful of these considerations, especially so in the current context that PSBs operate in, and regardless of the risk of being too prescriptive or repetitive, the Bureau has made comprehensive recommendations on code of conduct and ethics in PSBs as a sequel to its recommendations on governance reforms.

Objective

4. The recommendations made seek to attain the following objectives:

i. To have an internally strong and uncompromising vigilance mechanism which would give the requisite comfort to external agencies that PSBs meet the requisite standards to safeguard public interest.

[15] One of the mandates given to the Banks Board Bureau is to advise government on formulation and enforcement of a code of conduct & ethics for managerial personnel in PSBs

[16] The recommendations made here is also based on survey of various literature undertaken on the matter and includes, but not limited to, best practices recommended by supervisors and organisations in various domestic and overseas jurisdictions. The recommendations also factor in feedback received by the Bureau, solicited and otherwise from various stake holders including PSBs. Specific feedback offered by the Central Vigilance Commissioner has also been incorporated in these recommendations.

ii. To reinforce an independent internal ombudsman mechanism within the PSB to resolve customer complaints.

Tone at the Top

5. To oversee management's role in fostering and maintaining a sound corporate culture, the Board of Directors should be allowed to set the "tone at the top". In an ethical culture, employees feel comfortable speaking up and voicing their concerns, and they trust their colleagues will do the same. To make this happen, leadership has to set a tone that inspires trust in their own ethics and in their willingness to hear and respond to concerns. Fear of retaliation is a big deterrent for reporting misconduct, which prevents ethical cultures from thriving and prevents organisations from reaping the rewards. Therefore, a broader approach needs to be applied, going beyond the rules, whereby all kinds of misconduct risks can be proactively searched.

6. Accordingly, the following recommendations were made to bring harmony in the institutional structure at the top of the organisation:

i. Board of Directors (Board) should ensure that oversight of embedding values, conduct, and behaviours remains a sustained priority, with the primary responsibility resting with the CEO and other WTDs.

ii. Board should make certain that the CEO and other WTDs are highly visible in championing the desired values and conduct, and that they face material consequences if there are persistent or high-profile conduct and value breaches.

iii. Role of the members of the Board performing supervisory function must be distinct from the members performing its management function viz., the WTDs.

iv. The responsibilities and duties of the Board in its management function should be described in a written document and duly approved by the Board in its supervisory function.

v. Each committee of the Board should establish appropriate working procedures and have a documented mandate, including the scope of its responsibilities delegated by the Board in its supervisory function. Its decision making should not be dominated by a member or a small set of members.

vi. Each committee of the Board performing its supervisory function should have a chair who is an independent member.

vii. Members of the Board in its supervisory function, as a general principle, should not chair multiple committees unless this is justified after taking into account the overall composition, experience, knowledge and skills of the Board.

viii. There should be occasional rotation of chairs and members of committees of the Board taking into account the specific experience, knowledge, skills which are individually or collectively required for certain committees.

ix. The supervisory function of the Board should interact effectively with its management function. Both functions should provide each other with sufficient information to allow them to perform their respective roles.

x. Notwithstanding the overall responsibility of the Board, duties within the Board with respect to non-revenue generating functions should be assigned in a way that ensures the independence of the non-revenue generating functions.

xi. A member of the Board in its management function may be responsible for a non-revenue generating function provided that the member does not have other mandates which would compromise the members' internal control activities and the independence of the non-revenue generating function.

xii. When a head of a non-revenue generating function is not part of the Board, the respective position should be established at an adequate hierarchical level and be independent of the business areas it controls.

xiii. The head of a non-revenue generating function should not be subordinate to a person who has responsibility of a revenue generating function.

xiv. To this end, the heads of the Risk Management and Compliance functions should be directly accountable to the Risk Management Committee of the Board, and the head of the Internal Audit function should be directly accountable to the Audit Committee of the Board.

xv. The head of a non-revenue generating function should be able to report directly to the relevant committees of the Board performing its supervisory function and raise concerns where specific developments affect or may affect the bank.

xvi. Documented processes should be in place to assign the position of the head of a non-revenue generating function and to withdraw his or her responsibilities.

xvii. In any case, the heads of non-revenue generating function must not be removed without prior approval of the Board in its supervisory function.

xviii. Supervisory authorities should be promptly informed about the reasons of the appointment and the removal of a head of a non-revenue generating function.

xix. In order for the non-revenue generating function to be regarded as independent, the following conditions should be met:

   a. their staff does not perform any operational tasks that fall within the scope of the activities the non-revenue generating functions are intended to monitor and control;
   b. they are organically separate from the activities they are assigned to monitor and control;

xx. minutes of the meeting of the Board and its committees are so recorded that the supervisors are in a position to appreciate the quality of deliberations, critical decisions made as also the fact that dissenting views are indeed freely expressed and discussed within the decision making process.

Ethics and Vigilance Committee (EVC) of the Board

7. Given the above mentioned institutional architecture at the top to drive the right set of culture, an Ethics & Vigilance Committee of the Board should be constituted:

i. made up of only non-executives and, to the extent possible, majority of independent members.

ii. to be chaired by the non-executive Chairman.

iii. to be duty bound to protect employees for all bonafide decisions, witch hunting, prejudices, motivated and mischievous complaints.

iv. to ensure that staff who raise internal flags that lead to material risks being mitigated should be protected and celebrated.

v. to foster a culture of honesty and accountability to protect the interest of its customers and shareholders.

vi. responsible for establishing and overseeing the implementation of effective policies and processes to identify, monitor, manage, address and mitigate actual/potential misconduct.

vii. In order to do so, develop a formal written:

   a. code of ethics or a code of conduct policy
   b. conflicts-of-interest policy
   c. related party transactions policy

d. whistle-blower policy

e. vigilance and investigation policy

viii. to develop an objective compliance process for implementing these policies.

ix. responsible for ensuring and overseeing the integrity, independence and effectiveness of the banks internal alert policies and procedures, including those policies and procedures intended to protect staff who raise concerns from being victimised, e.g. retaliation, discrimination or other types of unfair treatment, because they have disclosed reportable breaches as also take appropriate measures against those responsible for any such victimisation.

x. appoint a professional Chief Ethics Officer with a sufficient team with necessary expertise who will drive and monitor the process as well as compliance on a day to day basis on all matter, except the vigilance and investigation functions, mandated to the EVC of the Board.

xi. to put in place and oversee the operationalisation of an appellate process in all fairness under the Grievance Redressal Mechanism for the employees of the bank under the Chief Ethics Officer.

xii. to put in place and oversee the operationalization in all fairness a dedicated whistleblowing function under the Chief Ethics Officer.

xiii. to oversee and be satisfied with the process rolled out by the Chief Ethics Officer by which appropriate disclosure is made, and/or information is provided to supervisors, relating to the bank's policies on actual and potential material conflicts of interest.

xiv. to put in place and oversee the independent internal ombudsman mechanism to ensure speed and fairness in resolution of customer complaints.

xv. to empower the Chief Vigilance Officer (CVO) to report directly to the EVC of the Board.

xvi. recognising that changing behaviours is a developmental program that cannot always be achieved through "standard" training and requires the involvement of senior leaders who champion the effort, develop programs for staff across all areas of the bank, tailored to the bank's circumstances that regularly reinforce what the desired values and conduct mean in practice.

xvii. to challenge the conventional wisdom on legal impediments which too often lead to "no action" being recommended by internal teams.

xviii. to ensure that robust penalties and appraisal processes are in place.

xix. through quality data and systems capture risks such as conduct and reputation risks across various businesses of the bank.

xx. to put in place a feedback system where the Board and senior management can systematically assess whether the espoused values are communicated and proactively promoted by management and staff at all levels so that the 'tone at the middle' and throughout the bank is consistent with the 'tone at the top'.

xxi. undertake systematic assessments on whether employees are aware of escalation processes and believe the environment is open to critical challenge.

xxii. assess if the existing mechanisms needs to be enhanced for employees to elevate and report concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing.

Code of ethics or a code of conduct policy and processes

8. The code of ethic or a code of conduct policy should:

i. clearly define acceptable and unacceptable behaviours linked in particular to financial misreporting and misconduct, economic/financial crime, including fraud, money laundering and anti-trust practices, bribery, corruption, market manipulation, mis-selling and other violations of consumer protection laws;

ii. clarify that in addition to compliance with legal, regulatory requirements and internal policies, everyone in the organisation is expected to conduct themselves with honesty and integrity and perform their duties with due skill, care and diligence;

iii. ensure that all are aware of the potential internal and external disciplinary actions, legal actions and sanctions that may follow misconduct and unacceptable behaviours.

iv. articulate practices, internal controls and compliance mechanisms that are conducive to limiting the opportunities for misconduct.

v. have an online process by which every employee in the organization is required to spend at least 60 minutes reviewing an online conduct training manual before signing the code of conduct statement.

vi. Put in place a process to identify material risk takers within the bank as also to identify high risk roles across functions in the bank and have the compliance personal randomly audit particular employees in high risk roles, transactions and business units.

vii. have a tracking process where in you can list out the revenue generated by each and every employee of the bank.

Conflict of interest recognition and management policy

9. Conduct & ethics gets challenged when there are instances of conflicts of interests. Conflict of interest means a situation of conflict between the duty of a person and private interests of an individual, which could improperly influence the performance of his or her duties and responsibilities.

10. Conflicts of interest may also arise as a result of the various activities and roles of the bank (e.g. where the bank extends loans to a firm while its proprietary trading function buys and sells securities issued by that firm), or between the interests of the bank or its customers and those of the bank's board members or senior managers (e.g. where the bank enters into a business relationship with an entity in which one of the bank's board members has a financial interest).

11. Conflicts of interest may also arise when a bank is part of a broader group – in the case of PSBs, the Government. For example, where the bank is part of a group, reporting lines and information flows between the banks, its parent entity and/or other subsidiaries can lead to the emergence of conflicts of interest (e.g. sharing of potential proprietary, confidential or otherwise sensitive information from different entities or pressure to conduct business on a non-arm's length basis).

12. Where these conflicts cannot be prevented, they should be properly managed based on the permissibility of relationships or transactions under sound corporate policies consistent with statutory and regulatory standards.

13. Mindful of the above mentioned factors, the conflict of interest policy should:

i. ensure that in all circumstances the interest of the bank should be central in the decisions taken.

ii. confirm that reporting lines and the allocation of responsibilities within the bank is clear, well-defined, coherent, enforceable and duly documented.

iii. ensure that there is a clear, transparent and documented decision making process and a clear allocation of responsibilities and authority within the internal control framework, including business lines, internal units and non-revenue generating functions.

iv. safeguard an adequate, effective and independent internal control framework that includes a clear organisational structure and a well-functioning risk management, compliance and internal audit functions that have sufficient authority, stature and resources to perform their functions;

v. identify the relationships, services, activities or transactions of a bank in which conflicts of interest may arise and state how these conflicts should be managed.

vi. cover at least relationships between a bank and:
   a. its various categories of shareholders;
   b. the members of its board;
   c. its staff;
   d. material suppliers or business partners;
   e. other related parties (e.g. its parent entity or subsidiaries); and
   f. legal or natural persons closely linked to persons under points (a) to (e) above.

vii. include the conflict of interest risk specific to the board in its supervisory function.

viii. ensure reorienting the role of the RBI & Government director representing the regulator and promoter respectively, to focus on the committees which undertakes supervisory functions of the board and dissociate themselves on those committees of boards of the banks which undertake management functions.

ix. Directors on the board should not be a member of any political party or related to any member of a political party.

x. set out procedures and measures to be adopted to identify, actual or potential conflicts of interest, assess their materiality, decide on mitigating measures and communicate any material actual or potential conflicts of interest of staff to the board.

xi. document procedures and measures towards:

   a. establishing adequate segregation of duties, e.g. entrusting conflicting activities within the chain of transactions or of services to different persons or entrusting supervisory and reporting responsibilities for conflicting activities to different persons;
   b. establishing information barriers such as physical separation of certain departments;
   c. preventing staff who are active in revenue generating functions from having inappropriate influence within the bank regarding other activities;
   d. establishing the staff's duty to promptly disclose internally any matter that may result, or has already resulted, in a conflict of interest;
   e. establishing a Board member's responsibility to abstain from voting/discussion/decision on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfil duties to the bank may be otherwise compromised;
   f. If any conflict of interest is identified at the Board level, the bank should issue a statement as to how this conflict has been satisfactorily mitigated or remedied including a reference to the relevant parts of the institution's conflicts of interest policy or any bespoke conflict management or mitigation arrangements.

xii. a rigorous review and approval process for members of Board to follow before they engage in certain activities (such as serving on another board) so as to ensure that such activity will not create a conflict of interest;

xiii. a member's duty to promptly disclose any matter that may result, or has already resulted in a conflict of interest;

xiv. process for recognition, discussion, approval, documentation, management of and disclosure of material conflict of interest at Board level, individually and collectively.

xv. the way in which the Board will deal with any non-compliance with the policy.

Policy on Related party transactions

14. One of the dimensions of recognising conflicts of the interest is the recognition of related party and the terms of engagement for transacting or otherwise with the related party. Accordingly, the bank shall put in place all that is required on dealing with related party transactions on the lines provided in the Companies Act, 2013 as well as the SEBI regulations.

15. The overall oversight in all matters to do with related party transactions will jointly be with the Audit committee and the EVC of the board.

16. Adequate procedures for transactions with related parties. For example: requiring transactions to be conducted at arm's length; requiring that all relevant internal control procedures fully apply to such transactions; requiring a binding consultative advice by independent members of the Board; an approval by shareholders of the most relevant transactions; limits to the exposure of such transactions; and preventing members of the Board from holding directorships in competing institutions.

Echo from the bottom

17. While the contents in the above paragraphs focus on the institutional structure to ensure the right tone at the top, there has to be a vigil mechanism for Directors and employees to report genuine concerns/breaches in any of the policy and practices. Accordingly, the following are the recommendations to ensure operationalization of these practices across the bank in order achieve the right behaviour as well as to have a feedback loop:

i. There is a need to build an open communication architecture between employees and managers towards building trust in leadership.
ii. Banks should put in place appropriate procedures for the staff to report potential or actual breaches of regulatory requirements, internal governance arrangements, through a specific, independent and autonomous channel.
iii. It should not be necessary that reporting staff has evidence of it, but a level of initial certainty that provides sufficient reason to launch an investigation.
iv. Reporting of breaches by staff should take place outside regular reporting lines viz.,

   a. through the Compliance function and Internal Audit function in case of unusual events, or
   b. an independent internal whistleblowing procedure through the Ethics function.

v. The alert procedures should ensure the protection of personal data concerning both the person who reports the breaches and the natural person who is allegedly responsible for a breach.

vi. The alert procedures should be made available to all staff within an institution.

vii. Information provided by the staff via the alert procedures should, if appropriate, be made available to the Board and the concerned functions;

viii. Where required by the staff member reporting an incident, the information should be provided to the Board and other responsible functions in an anonymised way.

ix. Banks may also provide for a whistle blowing process that allows handling information in an anonymised way.

x. Internal alert procedures should:
   a. be documented (e.g. staff handbooks);
   b. provide clear rules and be technologically enabled to ensure that confidentiality is guaranteed in all cases in relation to the person who reports the breaches committed within the bank, unless disclosure is required by law in the context of further investigations or subsequent judicial proceedings;
   c. ensure that confirmation of receipt to staff who raised potential or actual breaches is provided;
   d. ensure appropriate record keeping.
   e. ensure that the potential or actual breaches raised are assessed and escalated, including as appropriate to the relevant competent authority or law enforcement agency;
   f. ensure the tracking of the outcome of reported breaches;
   g. establish effective and reliable mechanisms to encourage institutions' staff to report to competent authorities on potential or actual breaches of regulatory requirements and internal governance arrangements.

h. These mechanisms should include at least specific procedures for the receipt of reports on breaches and their follow-up.
i. Without prejudice to the possibility to report breaches via the competent authorities' mechanisms, employees may also be encouraged to first try and seek to use the banks internal alert procedures.
j. In case of persistence of the breaches there should also be provision to escalate the same to the Chairperson of EVC and if it still persists, to the non-executive Chairman.
k. There should be clear time lines for taking appropriate actions for the breaches reported.
l. The resources available to the Chief Ethics Officer as well as the CVO should be adequate to ensure effectiveness and timeliness in taking appropriate actions.

xi. The risk management, compliance function and the internal audit function should each independently verify that these policies, mechanisms and procedures are correctly implemented and provide the requisite feedback to the Ethics and Vigilance Functions.

Internal Ombudsman

18. The internal ombudsman should be appointed by the EVC to put in place a policy and process for speedy and fair resolution of customer complaints. This should be a technology driven function so that complaints can be lodged online, despite having been received through off-line channels, and the process of resolution can be monitored with adequate escalations. This function should be adequately staffed.

Vigilance and Internal Investigation process

19. The vigilance and internal investigation process has to be robust so as to act as a sufficient deterrent against illegal/unethical conduct on the one hand and remove the propensity towards excessive risk aversion. Accordingly, the following recommendations were made:

i. Just as is the case with Private Sector Banks, a mechanism to be developed for a fully empowered Board and Vigilance Machinery within banks to deal directly with issues of commission in a time bound manner before referring the same to CVC and CBI.

ii. The PSB Boards through its EVC may be given the discretionary power to decide under which circumstances it would like to involve external agencies.

iii. Also, cases of vigilance enforcement against wholetime Directors and employees for decisions taken by them must be based on evidence of proven wrongful personal gain on account of business decisions. For levelling criminal charges, fraud must manifest itself through evidence of self-benefit. In loan and expenditure cases, deviations from procedure should not constitute the sole basis for initiating vigilance/criminal action.

iv. Specifically with reference to credit decisions, the report should be based on the facts available at the time of decision making by the functionary under investigation. There should be adequate evidence to tilt the balance of judgement in favor of an act of commission/malafide intent. It would be worthwhile to consider if a person of common prudence, working within the ambit of the prescribed rules, regulations and instructions, would have taken the decision in the prevailing circumstances in the commercial interests of the organisation.

v. Escalation to CVC/CBI should be made only after the EVC has approved the case. CVC/CBI can be appraised by the bank of such cases. The decision taken by the committee can be communicated to the CVC/CBI. In case CVC/CBI would still like to pursue the matter, CVC/CBI should within a certain time frame communicate their decision to the CVO of the bank.

vi. The pool of candidates who can apply for the CVO and the vigilance functions in a bank should be opened up by inviting applicants even from outside the PSB universe who have worked in the area of law enforcement, investigations, vigilance, forensic audit and banking supervision.

vii. The vigilance function within each bank to be adequately empowered with flexibility on staffing so that cases can be brought to closure within a maximum time frame of one year from the time that the same was discovered/brought to notice.

viii. Advanced analytics to be implemented so that employee specific information such as updates of income as well as assets/wealth can be captured and preventive/pro-active vigilance can be put in place as also employee conduct can be monitored and whistleblowers can be empowered.

ix. Specific default limits for staff accountability assesment may be reviewed so that lower amounts applicable can be subject to employee specifc pattern monitoring. These amounts could be pegged to the threshold limits set by RBI for fraud monitoring.

x. Have a tracking process in place for number of risk limit breaches for each employee per year.

xi. Prevention should address the behaviour of individuals/groups which is not aligned with the interests of customers, market participants and society at large.

xii. Launch an undercover surveillance team to observe front line behaviour.

xiii. All policy documents and standard operating procedure manuals of the bank should be revisited to ensure that there are no instructions which are vague, incomplete and are capable of multiple interpretations.

xiv. These standard operating procedure should be redrafted in such a way so that good governance can be achieved as part of the day-to-day work and adherence to ethical principles can be tested.

xv. In order to ensure the need to train/retrain the employees on the right procedures and processes, e-learning modules should be prepared on the basis of the policy,proceseses and manuals. The functionary should be able to complete the same succesfully before taking up the function assigned.

xvi. The tone at the top should be to ensure that decisions taken by all functionaries are recorded. Decisions which prima facie are not in tune with the existing instructions should be recorded with the reasons for decisions. Banks should document their decision and be able to justify their decision to competent authorities. To ensure that there is adequate deterrence against issue of oral instructions right from the Board level, employees should be empowered to report instances of oral instructions based on which they have been compelled to undertake any actions that would be a breach of any laid down policy/process/guideline/statute/regulations etc.

xvii. To avoid the potential possibility of compromise by officers of unequal stature leading to the senior most officer deciding the issue and the rest merely falling in line, committee system of grant of loans be restricted to only GMs (equivalent) and above. The minutes of such committee meetings of grant of loans should be accurate and detailed and should include notes of dissent if any.

xviii. Individual credit sanctioning limits should be granted upto the level of DGMs (equivalent) based on each officers assessed/demonstrable capability to take on such responsibilities.

xix. Excessive and unquestioned dependence on the opinions of third parties including but not limited to advocates, valuers, auditors should be reduced by ensuring that the opinions are verified properly and cautiously. There should be cross check of the opinion by mandating more than one opinion. Process of black listing of such third parties with suspected credentials should be in place including alerting other banks. If need be, necessary action should be taken against such professionals/third parties.

xx. Just as is the case where the treasury functions are separated into front office, mid office and back office, there should be clear segregation between credit origination (front office), credit underwriting (mid-office) and credit documentation/operations functions (back office). These functions should have separate reporting lines and should in no way influence the other.

xxi. A technology enabled system to track adherence to loan covenants before and after disbursal to ensure necessary compliance and to ensure that waivers granted are as per laid down guidelines.

xxii. Introduction of intelligent alerts, MIS, warnings on suspect transactions, intelligence, etc. in every aspect of operations which are operated.

xxiii. Considering that all transactions are being undertaken through various IT systems, introduce bank wide centralised concurrent/online review of the actions/decisions/transactions rather than the extant practice of disaggregated concurrent audit.

xxiv. In respect of procurement processes involving expenditure for acquiring various goods and services, there is a need to recognise that time to market is an important factor when it comes to public sector enterprises including PSBs and therefore there is a need to have a collaborative approach with CVC to develop :

   a. a process that would optimise the need to have fairness with the need to ensure quality and timeliness.
   b. a concept of materiality which excludes transactions/series of transactions of common nature below a threshold of Rs. 1 crore from the purview of CVC/CBI.

Terms of engagement with external service providers/outsourcing activities

20. A bank remains fully responsible for all outsourced services/activities and management decisions arising from them. Accordingly, the outsourcing policy should make it clear that an outsourcing does not relieve the bank of its regulatory obligations and its responsibilities to its customers. The policy should also cover intragroup outsourcing (e.g. by a separate legal entity within an institution's group) and take into account any specific group circumstances.

21. Therefore, equivalent standards prescribed in these recommendations should also cover external services providers/outsourcing to the extant legally permissible. There should be clear responsibility of the staff in the bank who would oversee adherence to these standards.

Responsibility of the Human Resource Function

22. The Human Resource function within the bank has to work in tandem with the EVC so that an eco-system is created within the bank where the desired values and conduct should be reflected in the daily habits and practices of employees—how they work; how they are evaluated; who is hired, promoted, and rewarded; and how employees act when managers are not present and when matters of personal judgment arise. Accordingly, the following recommendations were made:

i. The WTDs, management and all staff should be made aware that unacceptable behaviour including consequences for weak management oversight and transgressions including wilful blindness will engender appropriate disciplinary action.
ii. It has to be ensured that performance management does not reward individuals who do not meet a threshold of acceptable behaviour in alignment with the banks values and conduct expectations. The processes should ensure that misconduct and violation of bank culture come at a meaningful price for those responsible for such behaviours (for example, reduced compensation, termination, career limitation). Malus and clawback clauses in the compensation should be introduced and resorted to in order to address misconduct by an employee.

iii. At the same time performance management should provide scope to improve compensation and promotion processes to ensure they take account of desired behaviours.

iv. Therefore, a comprehensive set of indicators based on objective criterion should be developed to monitor and assess the adherence of individuals and teams to firm values and desired conduct.

v. Risk culture dashboards should be developed with reports to track progress across key culture attributes and indicators to track the frequency and treatment of both self-reported control and risk problems as well as whistle-blowing incidents.

vi. Despite a good tone from the top, the vast majority of middle management often revert to traditional performance criteria. This undermines the importance of conduct and values in the eyes of most employees, and reinforces the message that traditional performance is clearly the most important metric.

vii. To achieve all of the above, there is a need to formulate and dovetail a system-wide values and conduct evaluation process with an assessment template that incorporates adherence to each of the banks values in the extant performance appraisal system of each and every employee throughout the bank. The WTDs should at least have 10% weightage for this in the overall score, and the junior most employee should have at least 5% weightage for this.

viii. To aid the process a carefully designed 360 degree feedback exercise should be introduced that will provide robust insight on each employee to the HR function as also expose questionable behaviours.

ix. All employees and all levels of management should adhere to values, conduct, and behavioural expectations.

x. Business line management—the first line of defence—should shoulder primary responsibility for delivering the desired values and conduct. The second line of defence is about setting standards, monitoring, and providing advice to the first line. The third line of defence should be robust and mandated to test adherence to the stated standards.

xi. The remuneration of the non-revenue generating functions' staff should not be linked to the performance of the activities the non-revenue generating function monitors and controls.

xii. Remuneration levels in non-revenue generating functions need to be sufficient to attract high-quality individuals who can command the respect of the business. The designated second line needs to develop skill sets and priorities to be better equipped to deal with difficult judgments on values and behaviours and act as a more effective advisor to the first line.

xiii. Banks should ensure that full due diligence is completed on past employment history of potential new hires.

xiv. Staff rotation between revenue generating and non-revenue generating functions may be beneficial and help develop the desired firm-wide cultural mind-set.

xv. HR should develop capabilities to assess behaviour as a direct influence on compensation and promotion with clear consequences for dysfunctional behaviours.

23. These recommendations were made by the Bureau on March 31, 2017. The Bureau awaits latest updates from the DFS on the status of these recommendations.

Chapter -VII

Strategy

The Bureau has been given a mandate to help PSBs in developing business strategies. The Bureau believes that it is for Boards of individual PSBs to drive the overall strategy within its risk capacity. Therefore, the Bureau chose not to formally prescribe any specific strategy for respective PSB.

2. Nevertheless, the Bureau did make preliminary efforts to meet with the Boards of a few PSBs. These interactions were around the following five themes:

i. Board composition and vacancies;
ii. human resources development;
iii. investment in technology and business processes to enhance efficiency and reduce costs;
iv. stressed assets management; and
v. capital assessment.

3. However, lack of adequately manned and empowered Boards in most of the PSBs, made such meetings infructuous.

4. Ideally, by undertaking such engagements with a fully manned and empowered Board of PSBs, the Bureau could have been in a position to make an assessment of the relative strengths and weaknesses of a PSB as well as the diversity of competencies available at the Board level in a PSB to drive their respective long term strategy. These assessments would in turn help the Bureau in encouraging the Board of each PSB to offer sceptical, yet professionally constructive challenge to its management to ensure better outcomes. In other words, while business continue to be driven by the Boards, the Bureau could provide lateral thought process to the Boards of PSBs.

5. Specifically with reference to stressed asset resolution strategy, in May, 2016, based on the discussions at the inaugural meeting of the Bureau, the Bureau had sought a specific mandate to develop an independent perspective on stressed asset strategy and co-ordinated effort among PSBs towards recovery. While awaiting a response on the revised mandate sought and recognising the slow progress made by PSBs in resolving the issue of Non-Performing Assets (NPA), in June 2016, the Bureau took the initiative to co-ordinate with RBI, CVC and CBI to establish an Oversight Committee for the resolution of stressed assets.

6. The Bureau also facilitated a meeting of the Chairman/CMDs/MD& CEO's of PSBs with the Director, Central Bureau of Investigation and the Central Vigilance Commissioner. The meeting was co-chaired by the Governor, Reserve Bank of India along with the Chairman, Banks Board Bureau. However, since the Government had not acceded to the Bureau's request for a specific mandate on stressed asset strategy, the Bureau stepped aside from making any further efforts in the matter.

7. In June, 2017, given the mandate on strategy, the Bureau made its recommendations on consolidation of PSBs. The recommendations were made with an objective of keeping the long term interests of the employees, taxpayers and minority shareholders. The recommendations were mindful of the need to start the process with only those 'anchor PSB(s)' which would attain the same level of resilience as was the case with PSBs which underwent consolidation in the recent past. In a context of competition from technology driven private sector, the recommendations were made to reward relatively efficient capital allocation strategy and to raise the possibility of deriving the benefits of economies of scale in the shortest possible time.

Chapter -VIII

Capital

One of the mandates of the Banks Board Bureau is to help PSBs in its capital raising plan. Recognising that PSBs could be nudged to follow a sustainable business strategy if the major shareholder were to clearly articulate upfront in a transparent manner the rules of its capital allocation strategy, the Bureau has on its own undertaken capital assessments to arrive at the common equity capital projections of PSBs for the period till March 31, 2019, and beyond[17].

2. The approach to arrive at a methodology to undertake these assessments was to be iterative and to avoid complexity, ab initio, by introducing all possible variables. The focus was predominantly on credit risk - the dominant risk driver[18]. To arrive at a methodology, following questions required answering:

i. What had been the trend regarding slippage of assets into non-performing assets (NPAs)?
ii. What had been the observed recovery rate from the portfolio of NPAs?
iii. What was the existing stock of provision cover available on the existing stock of NPAs?
iv. What had been the trend regarding operating profits?
v. What was the headroom available for infusing external capital by dilution of the Government shareholding to 52%?
vi. What was the amount of capital required from Government to provide for expected losses from stressed assets?
vii. How should the remaining amount of capital committed by Government be allocated among the remaining PSBs to enhance the credit growth potential of PSBs?

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[17] This has been made possible by the performance data collected from PSBs, as part of the Bureau's mandate to put in place a data bank on performance of PSBs.

[18] While other forms of risk drivers do exist in PSBs, it was assumed that they do get recognised to some extent through income or capital charge – both of which has been factored in this methodology.

3. Keeping these questions in mind, the Bureau has built the following methodology:

i. Assuming Risk Weighted Assets to remain static and all else to remain the same, the Common Equity Tier-1 (CET-1) capital shortfall/surplus was estimated by comparing the CET-1 ratio of a PSB as on a past date with the 8% CET-1 ratio required to be maintained from March 31, 2019.

ii. The common equity capital that a PSB could raise from the market by diluting the Government shareholding to 52% from the levels prevailing as on the past date was estimated. While making this estimate it was assumed that the PSBs would be able to raise the capital at least at the latest available share price[19].

iii. The latest quarter's stock of Gross NPAs of a PSB was compared with its stock of Net NPAs to arrive at the provision cover currently available. Thereafter, the recovery rate observed during the past few quarters for the PSB was considered to arrive at the required level of additional provisions that will have to be made during the next few quarters till March 31, 2019 to cover for the expected losses on NPA as of the latest quarter[20].

iv. To forecast the stock of fresh NPAs that would arise till March 31, 2019, the average quarterly net slippage rate (i.e., net of recovery) observed during the last few quarters was compared with the net slippage rate observed during the latest quarter. If the slippage rate in the latest quarter was less than the average of the last few quarters, it was assumed that the slippage rate in each of the next few quarters till March 31, 2019 would not be more than the slippage rate of the latest quarter. Alternatively, if the slippage rate in the latest quarter was more than the average of the last few quarters, it was assumed that the slippage rate in each of the next few quarters till March 31, 2019 would not be more than the average of the last few quarters.

[19] This may not be a conservative assumption to make.
[20] It is early to forecast as of now the behavioural impact of the new insolvency and bankruptcy code on the recovery rate. This may be conservative assumption.

v. After factoring in for the recovery rate applicable to a PSB, it was assumed, very conservatively, that a provision cover of 100% would be held as on March 31, 2019 for the incremental NPAs which would arise during the period upto June 2018, 75% provision would be held as on March 31, 2019 for the incremental NPAs which arises during the period July 2018 to September 2018, 50% provision would be held as on March 31, 2019 for the incremental NPAs which would arise during the period October 2018 to December 2018 and 25% provision would be held as on March 31, 2019 for the incremental NPAs which arises during the period January 2019 to March 2019.

vi. These PSBs would be undertaking aggressive provisioning in the near future, and therefore, internal capital outflow through tax and dividends will be minimised.

vii. It was assumed that during the next few quarters the PSBs would earn at least the same operating profits that it earned in the previous few quarters[21].

viii. After factoring all the above, the final CET-1 capital shortfall/surplus projection as on March 31, 2019 was arrived at for a PSB.

ix. For those PSBs which were projected to have CET-1 capital shortfall, it was assumed that the Government will follow through on its implicit guarantee and provide the necessary common equity capital, just enough to ensure that a PSB was in a position to provide adequately for the stressed assets and meet the minimum regulatory CET-1 capital requirements as on March 31, 2019, and beyond. In response, it was assumed that these PSBs would reduce risk intensity (Risk Weighted Assets) on their balance sheets, reduce operating costs and monetise assets.

x. For those PSBs which were forecasted to have a capital buffer, even after providing adequately for the expected losses, it would be possible to project as to for what period would this surplus be adequate for credit growth. This projection was made based on the following assumptions:

   a. Credit growth (RWA growth) will be 1.5 times the nominal growth in GDP.

[21] It is a conservative assumption to make considering that increase in non-core income could be set off by the less likely increase in treasury profits.

b. The nominal growth rate of GDP was assumed to be 12% (Real GDP growth rate of 8% and a rate of inflation of 4%)
c. Based on these a relatively optimistic credit growth rate assumption of 18% y-o-y was made.

xi. The pool of capital commitment available to these PSBs, after the Government has made available to those PSBs the capital required for adequately providing for the expected losses, was assumed to be made available based on the percentage share of each of the PSB in the total operating profit of the PSBs (with capital buffers) together for the last few quarters.

4. It was also recognised that divergence between the projections *vis-a-vis* the actual outcomes would emanate from the degree and direction of changes between the look back period and the projection period in the following variables:

i. Rate of slippage into NPAs
ii. Rate of recovery from NPAs
iii. Market capitalisation
iv. Operating profits
v. Risk Weighted Assets

5. Sharing of this methodology in the public domain would help the Bureau in further enhancements through feedback and perhaps helps the majority shareholder to clearly articulate upfront in a transparent manner the rules of its capital allocation strategy.

6. The question of capital infusion by the majority shareholder in the near future will continue to arise in a context where the objective is to retain the majority shareholding above 52%. However, despite the mandate to the Bureau on capital, the DFS has not engaged with the Bureau in deciding the allocation of capital to PSBs.

Chapter -IX

Human Resources

The Public Sector Banking System has a human resource count of a little less than a million. The collective performance of these resources who comprise around 0.05% of the nation's households have a bearing on the performance of the entire economy. The scale of economic responsibility that the country has entrusted these individuals is unparalleled. It would require the highest standards of leadership to prime them to turnaround the current situation.

2. Various recommendations made by the Bureau is to nudge the state to provide an empowered ecosystem to the human resources in PSBs that would help realise its true potential, and in doing so demonstrate that performance can indeed be ownership neutral.

3. When it comes to human resources, the specific mandate to the Bureau is as follows:

i. To help banks to develop a robust leadership succession plan for critical positions that would arise in future through appropriate HR processes.

ii. To advise the Government on evolving suitable training and development programmes for management personnel.

4. After having made its recommendations on all the other mandates, the Bureau has now focussed its attention on the above two mandates. It was recognised early on that when it comes to human resources, there was a need to have ownership of the stakeholders for any initiatives undertaken. It was also recognised that the outcomes from any of these initiatives would be visible only in the medium to long term and would be dependent on the degree of sustained implementation of various other recommendations made by the Bureau.

5. The institutional perimeter given to the Bureau as a recommendatory body does offer its own challenges when it comes to rolling out the initiatives under the two mandates mentioned above. Nevertheless, after multiple rounds of parleys for almost a year with various stakeholders, the Bureau acknowledges and appreciates the initiative taken by Indian Banks' Association (IBA).

6. Accordingly, in November 2017, the Bureau gave the following two mandates to the IBA.

i. To appoint a "Knowledge Partner" to the Banks Board Bureau to design, implement and institutionalise a flagship leadership development strategy for Public Sector Banks in India; and

ii. To appoint an "Advisory Firm" to assist the Banks Board Bureau to assess the leadership competencies and potential capabilities of personages appearing in the process for appointment as wholetime Directors of Public Sector Banks in India

7. Once the IBA completes the above two mandates, the Bureau along with the PSBs would be in a better position to embark on a journey to develop future generation of leaders from within the PSB universe to take on competition in an increasingly dynamic and technology driven environment.

8. The Bureau is also currently exploring, with a committee of senior bankers appointed by IBA, the best possible approach to enhance and develop, through training interventions, the professional competencies of employees manning each and every desk across various levels. The Bureau would be sending its recommendations to the Government on this mandate in due course.

Chapter -X

Future role

The previous chapters of this compendium provides details of the mandate given to the Bureau and the distance the Bureau has covered, so far, in performing its mandate. To better appreciate the progress made so far on each of the mandate, a summary is provided below:

Sl.No	Mandate	Status
a.	to recommend the selection and appointment of wholetime Directors ;	No pendency at the Bureau
b.	to recommend the selection and appointment of non-executive Chairman;	Progress contingent on implementation on various recommendations made by the Bureau and elaborated in this compendium
c.	to advise the Central Government on matters relating to appointments;	No pendency at the Bureau
d.	to develop an appropriate methodology to enable the search and selection of high calibre wholetime Directors of PSBs;	Work in Progress
e.	to advise the Central Government on matters relating to confirmation or extension of tenure and termination of services of the Directors;	No pendency at the Bureau
f.	to advise the Central Government on the desired management structure at the level of Board of Directors, and, for senior management;	No pendency at the Bureau
g.	to advise the Central Government on the formulation and enforcement of a code of conduct and ethics for managerial personal;	No pendency at the Bureau
h.	to help banks to develop a robust leadership succession plan for critical positions that would arise in future through appropriate HR processes including performance management systems;	Work in Progress
i.	to advise the Central Government on evolving suitable training and development programmes for management personnel in PSBs;	Work in Progress

Sl.No	Mandate	Status
j.	to build a data bank containing data relating to the performance of PSBs and share the same with Central Government;	No pendency at the Bureau
k.	to build a data bank containing data relating to the performance of senior management and the Board of Directors of PSBs and share the same with Central Government;	Progress contingent on implementation on various recommendations made by the Bureau
l.	to help the banks in terms of developing business strategies and capital raising plan and the like; and	Reasons for inadequate progress has been elaborated in the compendium
m.	any other work assigned by the Government in consultation with Reserve Bank of India.	No pendency at the Bureau

2. Considering the experience gained over the functioning of the Bureau and encouraged by the suggestion from the Finance Minister, Government of India, that the Bureau members work out a framework and roadmap that they perceive for the Bureau which can be discussed with the Finance Minister, the Chairman of the Bureau along with members[22] had reflected on the future role of the Bureau.

3. After due deliberations, on July 26, 2017 in a letter addressed to the Finance Minister, Government of India by the Chairman, Banks Board Bureau, the following points were made for consideration:

i. The Banks Board Bureau has been a landmark creation of the Government. It has been hailed as a path breaking policy initiative of the Government, in its attempt to professionalise the functioning of public sector banks. The concept of Banks Board Bureau had emerged from the Report of Dr P J Nayak. The said Report has predicated its role on some basic parameters, which need to be followed, for the Bureau to be effective and thus ensure the credibility of Government. Going forward, if this initiative has to gain credence, the Government and its functionaries will have to decide how this institution can ensure arm's length functioning of the executive from the professional working of public sector banks.

[22] other than the ex-officio members

ii. The Bureau has made recommendations on various issues in its remit, such as the ones made under the overarching theme of Governance, Reward and Accountability Framework (GRAF) in Public Sector Banks. These recommendations made by the Bureau, seek to address the root cause of the challenges presently faced by the PSBs. The Bureau is not aware of the progress made in this regard and there has been no further engagement with Government.

iii. If the Government does indeed desire to make the Bureau address issues of governance around PSBs in a holistic manner and make its output effective, there is need for an organic relationship between Government and the Bureau.

iv. The Bureau, as a body of experts on public sector banking, would be able to provide greater utility to the Finance Minister on matters relating to the governance and performance of PSBs, if there were to be greater organic linkage and dialogue with the Finance ministry. At present the body is merely functioning as an appointment board.

v. India now deserves a public sector banking system which can offer a long term sustainable growth rate rather than a public sector which amplifies the excesses of the credit boom with extreme risk aversion during credit bust and the attendant reliance on the tax payer's funds.

vi. To make this happen requires reworking of nearly five decades of institutional structures and processes which was put in place with the nationalisation of banks. It is very much in the realms of possibility to rework the same while the Government continues to retain at least 51% of the shareholding in PSBs[23] recognising the strategic importance of Public Sector Banks in India's developmental framework.

vii. Keeping the above context in mind the Banks Board Bureau (Bureau) seeks the following specific mandates going forward:

a) **PSB consolidation**: Engage with various stakeholder and offer its advice to the Government to ensure that PSB consolidation is least disruptive,

[23] Diversifying the shareholder base of PSBs, is a *sine qua non* to improving the overall valuations of PSBs on a sustainable basis as well as a tool to enhance the common equity capital of PSBs that will help the domestic economy to return to a high growth phase in the medium term.

minimise the reliance on the tax payers and maximise the outcomes for all stakeholders.[24]

b) **IDBI Bank Ltd**: Rework the Articles of Association of IDBI Bank Ltd., so that it mirrors to the extent possible the Articles of Association of other such institutions which were earlier in the Public Sector.

c) **Governance, Reward and Accountability Framework (GRAF)**[25]: The Bureau will provide an independent feedback to the Finance minister at least on a half yearly basis on the degree of implementation of its various recommendations related to GRAF. In order to provide the independent feedback, the Bureau will engage with the Boards of PSBs, the Department of Financial Services and the regulatory & supervisory functions of RBI.

d) **Strategise on Asset Quality Resolution**. To develop an independent perspective on asset quality in general and stressed asset resolution strategy, in particular, that transcends business cycles as also possible way for concerted and co-ordinated effort among PSBs towards recovery and, more so, in the case of wilful defaulters.

e) To engage with the PSB Boards to help build capacity to attract, retain and nurture both talent and technology - the two key differentiators of business competencies in the days to come.[26]

f) To present its quarterly assessment to the Finance Minister on the relative performance, the respective capital assessment and growth assessment of each PSB[27].

g) Put in place an arrangement for engagement of the Government with the board of PSBs rather than direct engagement with the management[28].

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[24]It is imperative for the public sector banking system to reap various efficiencies of economies of scale.

[25]Adoption of best practices in corporate governance in PSBs will necessitate reworking of the institutional arrangements by which the major shareholders currently engage with PSBs. The objective of such engagement will be to help prepare the public sector banks to take on the competition, have the ability to appropriately manage and price risk across business cycles, develop resilience to generate internal capital and have the capacity to generate external capital warding of the moral hazard of counting on the scarce budgetary resources of tax payers.

[26]While engaging with the Boards of PSBs, the Bureau will be mindful of the need to have a fully empowered board in each and every PSB. It is these boards which should drive the overall strategy of a bank within its risk capacity and also act as custodians who should reconcile the diverse interests of various stakeholders. The Bureau's role will be to engage with these boards of PSBs to offer its professional sceptical challenge on behalf of the majority shareholders.

[27]The intent being to follow a collaborative approach between various institutions towards a common goal.

[28]Which presently makes the boards of PSBs appear as a superfluous presence.

h) To make recommendations on termination / extension of services of the Government appointees /nominees on boards of PSBs.

i) To the extent that RBI finds itself drawn into the present role with respect to PSBs which is not on the same lines as its engagement with the banking entities which are not in the public sector, the role to be played by the Bureau.[29]

viii. These mandates are being suggested to further reinforce and institutionalise the zero interference policy of the Government. The Bureau does not seek an executive role. The Bureau, which will be made up of members with the requisite expertise in the financial sector, seeks to be a recommendatory body which will provide the necessary independent feedback to the Government on its reform, perform and transform agenda and in doing so, reinforce the interests of the tax payer.

ix. To discuss these matters further with the Finance Minister, Government of India, the members of the Bureau would like to schedule a meeting at a time convenient.[30]

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[29] With the advent of the Banks Board Bureau, it should be possible for reducing the conflict of interests that the RBI finds itself in as a regulator and supervisor of the banking entities in the public sector. In this regard, the RBI's role as a regulator and supervisor should be made ownership neutral.

[30] The Bureau continues to await a meeting. Post facto addendum made on April 02, 2018 as follows: During the meeting of the Bureau held on March 26, 2018, the Chairman, Banks Board Bureau informed the members that the Finance Minister had been kind enough to provide the opportunity of engaging with him on various occasions where issues were discussed and taken forward.

Banks Board Bureau

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