

Board Conduct in Banks

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1. Introduction

The global financial crisis called into question the role played by board oversight in ensuring effective governance of banks and financial institutions. For instance, the UNCTAD report on “Corporate governance in the wake of the financial crisis” mentions as the first of its five key messages: “...reform efforts (in financial institutions) should focus on: a) strengthening board oversight of management, b) positioning risk management as a key board responsibility.” Several multilateral and national reports have highlighted failure of bank boards in effectively assessing risks as well as in excessively conforming with laid down procedures.⁸

Prior academic research has concentrated on how the structure of boards, such as its size, the percentage of independent directors, the portfolio of expertise of board members, the average age of board members, the number of busy directors, etc. affects governance in banks (see Mehran, Morrison, and Shapiro (2011) for a comprehensive review). However, board conduct and its relationship to governance in banks has not received attention. In this paper, we attempt to fill this gap. We assemble a unique dataset comprised of minutes of board meetings and board-level committee meetings of 29 Indian banks. We discipline our analysis of this data using a simple theoretical framework to interpret our empirical findings.

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8 For a select few, see Senior Supervisors Group (2014); Walker (2009); UNCTAD (2010); Shleifer (2011); Group (2012). Specifically, Walker (2009) mentions about the perils of board “groupthink,” which “is a type of thought exhibited by group members who try to minimize conflict and reach consensus without critically testing, analysing and evaluating ideas.” The report also recommends that “board-level engagement in risk oversight should be materially increased, with particular attention to the monitoring of risk and discussion leading to decisions on the entity’s risk appetite and tolerance.”

2. Methodology

Compared to American firms, where the minutes are subject to scrutiny by legal experts (Schwartz-Ziv and Weisbach (2013)), these minutes are significantly more detailed. We transform the minutes into a quantitative database, which enables us to draw inferences about the quality and quantity of discussions relating to the various functions in a bank. We classify the issues that are tabled in these meetings into five categories:

- (a) Risk
- (b) Business strategy
- (c) Financial reporting
- (d) Regulation and compliance
- (e) Human resources

For each issue, we record the category to which the issue belongs and whether the board deliberated at length on the issue or not. We record an issue as having been deliberated if the board (i) asked for more information, (ii) elaborately discussed the issue, and/or (iii) the board rejected a proposal or modified it. We also use text analysis methodology suggested by Muslu, Radhakrishnan, Subramanyam, and Lim (2014) to analyze whether an issue is forward looking or not.

Methodologically, an analysis of board and board-level committee meeting minutes provides several advantages:

- a. First, while board structure captures *de jure* aspects of the board (i.e. according to the letter of the law), board minutes capture the *de facto* working of the board (i.e. the actual workings of the board).
- b. Second, board minutes enables us to understand the complexity and nuanced details of the topics brought up in the board and board-level committee meetings.
- c. Third, because banks are highly regulated entities, bank boards may devote excessive effort to comply with laws and regulations. Such a concern is, in fact, voiced in the report of the G-30 on the financial crisis: “Boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk, and talent issues are making

a critical mistake (page 13).” Examining the minutes enables us to draw these distinctions.

- d. Finally, and most importantly, analysis of the minutes allows us to assess the quality of discussions in the board and board-level committees.

3. Findings

We report the following findings. We find that the average number of issues brought forth before a bank board is 50 as compared to 8.5 in boards of industrial firms as shown in Schwartz-Ziv and Weisbach (2013). The large number of issues stems primarily from the fact that banks are heavily regulated entities as opposed to industrial firms. Regulatory and compliance related issues account for most (41%) of the issues tabled followed by issues relating to business strategy (31%). Issues relating to risk only account for 10% of the total issues. Statistical tests of means as well as that of first-order stochastic dominance among the various distributions confirm this ordinal ranking. Using this finding and our theoretical arguments and predictions, we infer that bank boards are under-investing in matters relating to risk and over-investing in matters pertaining to compliance.

To test if the boards resort to just “box ticking” or deliberate on the issues at length, we examine the proportion of issues deliberated. On average, only 20% of the issues that are tabled are deliberated at length. A natural question to ask would be whether boards are discussing risk in the board-level committees. We examine the minutes of risk management committee (RMC) meetings to understand the quality of risk discussions. On average, RMC meets only a third of the times the board meets and deliberates at length only on 28% of the issues tabled. The RMC spends a larger portion of its time receiving updates and reports than ratifying decisions. Finally, only 25% of the issues tabled in the RMC are forward-looking in nature.

Collectively, these findings provide important insights into the conduct of bank boards. First, our findings support the concern voiced in the report of the G-30 on the financial crisis that “boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk, and talent issues are making a critical mistake.” To be precise, we only show

evidence supporting the concern that boards may be permitting their attention to be diverted disproportionately into compliance at the expense of strategy and risk issues. Second, our evidence suggests that merely mandating a RMC is insufficient to ensure adequate risk oversight by the board. The Dodd Frank Act (2010) requires large financial institutions to establish a separate RMC comprised of at least one risk management expert. In India, the Reserve Bank of India (RBI) has mandated RMC since 2002. Yet, the unflattering evidence about the conduct of RMC highlights the oft repeated notion that “form does not lead to substance!”

Finally, we find only five cases of recorded dissent among the board of directors, which suggests high degree of conformism and lack of adequate challenge in bank boards. The Walker Report (2009), which reviews corporate governance in UK banks, mentions that the sequence in board discussion should start with an idea being presented, followed by the idea being challenged. Our evidence of lack of challenge in bank boards is thus consistent with the anecdotal evidence mentioned in this report.

4. Concluding Remarks

To our knowledge, ours is the first study to examine the conduct of bank boards. Our study thus complements research that focuses on how the structure of bank boards - board size, board independence, and characteristics of the board members including their financial expertise affects bank governance (see Mehran et al., 2011 and the studies cited therein). Our work also relates to the literature examining the structure of risk-management in banks (Ellul and Yerramilli (2013), Aebi, Sabato, and Schmid (2012), Mongiardino and Plath (2010)). Our study closely resembles Schwartz-Ziv and Weisbach (2013), who examine board conduct in non-financial firms and relate their evidence to various theories by carefully analyzing board minutes of Israeli government-controlled companies. In contrast to these studies, we focus on board conduct in banks and financial institutions.