Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.4, No.7, 2013

Formulation of Corporate Governance Index for Banks in India

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Abstract
This paper attempts to develop a mechanism to evaluate the quality of Corporate Governance for the scheduled commercial banks in India. Corporate governance in banks has become an imperative issue post the global financial crisis of 2007-08. A lot of research has been done since the eruption of the aforesaid crisis on the corporate governance of financial institutions. The paper first reviews the literature on the corporate governance of financial institutions, especially the banks. The study henceforth, explores corporate governance in banks as a distinct concept that has assumed importance globally over time. Subsequently, the paper reviews the current state of corporate governance in India and explores the scope for improvement of the same. The study eventually links both the assessments and places factors critical for evaluation of corporate governance of banks in the Corporate Governance Index. The benchmark for the Index was Clause 49 of Listing Agreement of the Stock Exchanges in India. The Index thus formulated consists of essential factors like board of directors, audit committee, remuneration committee, nomination committee, risk management, related party transactions and disclosures. These factors were delineated further by defining sub-elements under each head. These sub-elements were assigned individual scores on the basis of review of literature performed while selecting factors. The result of this study was a Corporate Governance Index designed especially for Indian banks. This paper would provide a guideline to academicians, practitioners and policymakers for evaluating quality of corporate governance of an Indian bank.
Keywords: corporate governance, corporate governance index, India, scheduled commercial banks, clause 49.

1. Introduction

This paper provides guidelines for assessment of corporate governance of Banks in India. The objective of this study is to determine the relevant and most critical factors responsible for evaluating the effectiveness of corporate governance of banks in India.

A large number of financial institutions collapsed during Global Financial Crisis (GFC) of 2007-2008. It was realized that macroeconomic factors were majorly responsible for this crisis. The financial firms were exposed to the fallout of the leveraged loan market, illiquidity in the asset backed commercial paper market and a steep fall in the value of subprime mortgages and of structured financial product (Senior Supervisor's Report, 2009). The crisis led to lack of confidence in the global financial markets leading to a destabilization of the global financial system. Through recent studies it was concluded that the banks had a significant role to play in magnifying the effects of this crisis into a banking crisis due to flawed risk management systems and awry asset-liability management (Brunnermeier, 2009). Further, the ‘performance’ based incentives of bank CEOs, flawed internal compensation and control systems led to serious agency problems in the banks (Kashyap, Rajan, & Stein, 2008) that in turn gave rise to skewed risk management and financing policies in these banks. Thus, various studies indicate that the weak and inadequate corporate governance mechanisms of the banks were among the main reasons behind the GFC (Marcinkowsa, 2012) (Yeoh, 2010) (Laura & Berg, 2010) (Lapido & Nestor, 2009). This paper underlines the need to evaluate the corporate governance of the banks.

Banks accept deposits and lend money thus collected. It is imperative that the interest of the depositors is protected and there is confidence amongst the depositors to put their savings in banks. Banks determine which end-users receive financial resources and provide a means of payment. They also serve as a tool for the execution of monetary policy. Banks need to be perceived as accountable to depositors and credible in order to manage the potential risk of a run on bank deposits. Banks suffer from high debt-equity ratio and there is difference in maturity between liabilities and assets. Also, the banks' main assets (loan portfolio) are perceived to be quite opaque to outsiders. Poor corporate governance of banks may lead to failure of the bank. (OECD, 2006)

Thus, failure of a bank has serious connotations for effectiveness of the financial system in an economy. Thus, the importance of corporate governance in banks is different from the corporate governance of any other company. The paper has been prepared with this view that corporate governance of banks needs special attention. This is because the directors and the management of banks need to take care of the interest of non-shareholding stakeholders, i.e., depositors.

2. Phases for Formulation of Corporate Governance Index

For formulating corporate governance Index for Indian banks there is a need to first understand the nature of corporate governance of banks in general. Then the paper examines the state of corporate governance in India. Finally, the guidelines given by various regulatory bodies for corporate governance in banks need to be kept under consideration while formulating the index.

2. 1 Corporate Governance in Banks

Banks play the role of financial intermediation in an economy. Hence, the public and the market are highly sensitive to any difficulties potentially arising due to weaknesses in the corporate governance of Banks. After the financial crisis erupted in mid-2007, the Basel Committee on Banking Supervision revisited its guidelines on bank governance (Bank for International Settlements, 2010). The Committee has summarized the key focus areas as: board practices, senior management, risk management and internal controls, compensation, complex or opaque corporate structure and disclosure and transparency. Poor corporate governance in banks leads to increased public costs and possibility of broader macroeconomic implications such as contagion risk and impact on payment systems. The principles charted out by BIS have been kept in mind while formulating the Index.

OECD had conducted an Asian Roundtable on Corporate Governance Task Force on Corporate Governance of Banks (OECD, 2006). The Policy document identifies the most critical issues for corporate governance that affect banks in Asia. The task force believes that many Asian jurisdictions lack the institutional infrastructure like, sufficient resources, experience, focus and know-how necessary for effective enforcement of the corporate governance policy framework. Also, Asian banks play a dominant role in regional finance but have rather immature capital markets. In such a milieu, it becomes very important that there is a need to tackle institutional constraints and weaknesses in order to have effective corporate governance in banks. The policy brief gives special mention to the state-owned commercial banks (“SOCBs”) and family-owned banks (“FOBs”) as these are quite dominant in Asia. In case of FOBs, related party transactions hold importance. However, in case of SOCBs the role of government as an active accountable owner has to be carried out in such a manner that it doesn’t interfere with the day to day management of bank. For listed banks, the policy document stresses on the separation of ownership and control (i.e., the agency problem).

Thought Arbitrage Research Institute (TARI, 2012), evaluates the role of RBI as a regulatory body of the banking industry in India. RBI plays an important role in laying down the corporate governance norms for the Indian Banking Industry. RBI works under the Board for Financial Supervision (BFS) which in turn inspects the banks using “CAMELS” (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems & Controls) Approach. RBI monitors bank governance through three activities, viz. Disclosure and Transparency, Off-site surveillance and Prompt corrective action. Disclosure and Transparency is monitored through the regularity and thoroughness in the financial reporting of the Indian banks as per the accounting standards. The Off-site surveillance mechanism checks the movement of assets, its impact on capital adequacy and overall efficiency and adequacy of managerial practices in banks. RBI gives ‘Peer Group Comparison’ on critical ratios to maintain peer pressure on individual banks for better performance and governance. Prompt corrective Action is a part of the Basel II requirements through which RBI initiates corrective action in case there is an irregularity in three ratios –Capital Adequacy Ratio, Non-Performing Assets Ratio and Return on Assets. BFS also monitors the quality of audit done by the banks.

Asian Development Bank Institute conducted a study on the practices of corporate governance in the banking systems in post-crisis period (1998-2003) in Asia (Sang-Woo Nam, 2006). The study covers four Asian countries –Indonesia, Republic of Korea, Malaysia and Thailand. The study involved a questionnaire survey of 52 banks in Asia. It focusses on the following factors:

1. Risk management within the Banking Organization
    a. General risk management
        i. Portion of total employees principally assigned to risk management in general and particular areas of credit risk market, and operational risk management.
        ii. The involvement of the board of directors in approving the strategy and major policies of the bank for measuring and managing risk
        iii. The frequency of reporting of risk exposure to management
        iv. The frequency with which the bank conducted reviews of risk management procedures
    b. Internal control function
        i. Management oversight and control culture
        ii. Control activities and segregation of duties
        iii. Information and communication
        iv. Monitoring activities and correcting deficiencies

2. Risk management in specific areas
   a. Credit Risk
   b. Market Risk
   c. Operational Risk

The study concluded that better operational and credit risk management is positively correlated with profitability and better market risk management is positively correlated with better asset quality. The study also investigates the level of public disclosure by banks regarding risk exposure. It uses the best practices laid down by the Basel Committee for credit risk disclosure as a reference to evaluate the same. Interestingly, the banks surveyed were not found to be satisfactory on this parameter.

Erkens, Hung, & Matos (2012) investigate the impact of corporate governance on financial firms' performance during the 2007-2008 financial crisis. This study examined the relation between firm performance and corporate governance by regressing stock returns during the crisis as buy-and-hold returns from January 2007 to September 2008 on measures of corporate governance and control variables. The study found that firms with more independent boards and higher institutional ownership posted worse stock returns during the crisis period.

2. 2 Corporate Governance in India

The World Bank published a Report on the Observance of Standards and Codes (The World Bank Group, 2004) in order to assess the corporate governance in India. This evaluation is done by benchmarking India's corporate governance framework and company practices against the OECD Principles for Corporate Governance. The study has appraised the Indian companies on the adherence to the OECD principles in India methodically and has assigned ratings on each factor & sub-factor according to the OECD Benchmark. The report identifies a few problems areas in regard to the corporate governance practices in India. As per the report the sanctions provided by the Companies Act in India, for the violation of corporate governance norms were inadequate. The Stock Exchanges were not able to impose fines on market intermediaries. There were about 3,000 companies that were either illiquid or in the breach of listing rules. Hence, an efficient mechanism is needed to allow minority shareholders to exit from such investments at a fair price. The Department of Company Affairs, Stock Exchange Board of India and the stock exchanges share jurisdiction over listed companies. This creates a potential for regulatory arbitrage and weakens enforcement. The report stresses that there should be strong focus on director professionalism. It is suggested that there should be establishment of director training institutes. Lastly, the report recommends that the institutional investors should attend shareholders meetings and vote in order to promote shareholder activism. Also, the institutional investors should nominate independent directors to the boards of their portfolio companies. In this manner, the companies would avoid appointing their current or retired employees as independent directors that leads to conflicts of interest in the exercise of their fiduciary duties.

The role of independent directors in Indian Companies is being questioned since the controversies of year 2009. There was a corporate scandal at Satyam Computer Services and a hullabaloo regarding the role of Mr Nimesh Kampani as an independent director at Nagarjuna Finance. This led to strict scrutiny of Independent directors in India and hence at least 620 independent directors resigned from the boards of Indian companies. A study done by Mathew & Khanna (2010) carried out interviews with the independent directors in India. The authors probed the opinions of independent directors regarding the clarity amongst these directors for their role in the boardroom. The responses by and large showed that we are far from following the ethos of corporate governance in its true spirit. In fact, the independent directors are quite confused about their role in the board. The paper also lists legal requirements of Clause 49 of Stock Exchange Listing Agreement by SEBI for corporate governance disclosure. It also updates on the voluntary guidelines produced by Ministry of Corporate Affairs (developed by Confederation of Indian Industry (CII), The Task Force chaired by Naresh Chandra and The Council of Institute of Company Secretaries of India (ICSI) in December 2009). This recent reform stresses on following points:

1. Nomination Committees
2. Executive Sessions
3. Access to Management and Other resources
4. Remuneration
5. Related Party Transactions
6. Independent Director Liability
7. Shareholder Activism
8. Director Training.

A study done by Kumar & Upadhyaya (2011) attempts to develop a Corporate Governance Index for Commercial Banks of Nepal by taking the OECD code of Corporate Governance a benchmark. There have been some irregularities in the governance of Nepal Development Bank Ltd and a few other prime commercial banks in Nepal. The authors therefore, attempt to construct an Index in order to assist the promoters, common shareholders, creditors, investors and other stakeholders of the banks in Nepal.

Marcinkowsa (2012) conducts a study on the corporate governance mechanisms in banks, diagnoses the concern areas and prescribes remedies for the industry. She proposes that banks should focus on the core banking services rather than investment activities. Also, there should adequate loans-deposits synchronization, asset-liability maturity match and level of leverage. The banks should link the remuneration of its executives according to their performance and risk exposure. However, the bonuses should be conditional on the long-term results that are sustainable. The internal and external auditor should be hugely accountable and should be liable to report any non-conformance to the supervisory agencies.
Sarkar, Sarkar, & Sen (2012) constructed a Corporate Governance Index for 500 Indian large listed firms. The index is constructed using 4 important mechanisms of corporate governance:

1. Board of Directors
2. Ownership Structure
3. Audit Committee
4. Auditor

The index has been created in two steps. First, a sub-index for each of four corporate governance components listed above was created. Secondly, the average of these sub-indices is calculated to compute the corporate governance index of a company. The paper reveals that companies with better corporate governance structures have a better rate of return in the market. Thus, Indian markets reward the companies with sound corporate governance mechanisms.
A study done by Kumar N. (2012) tested the impact of non-executive directors and insider ownership on the firm value of 157 Indian firms. The study was done using data from the Prowess database to test the correlation between Tobin's Q and non-executive directors. Interestingly, the grey directors (affiliate outside directors) give a negative impact on value of the company. This negative impact of grey directors is offsetting the positive (not very significant) impact of independent directors (non-affiliate outside directors). The results of other studies (Khanna & Palepu, 1999) (Kota & Tomar, 2010) shockingly reveal that promoter ownership is positively related to firm value. This study also corroborates the findings of these other studies stating that this insider ownership has a weak but positive impact on firm value.
The crisis of 2008 led to a revelation of inherent weaknesses in the corporate governance and control procedures of the large financial institutions globally. Senior Supervisory Group of Bank for International Settlements published a report on Risk Management Lessons from the Global Banking Crisis of 2008 (Senior Supervisor's Report, 2009). The report lists a number of reasons due to which the crisis occurred. Among many other, the report point out that there were weaknesses in the corporate governance of the financial firms:

- The unwillingness or inability of the board of directors and senior managers to articulate measure and adhere to a level of risk acceptable to the firm. Several senior managers admitted that there was a disparity in the risk that the firm took, and the risk that was 'perceived' by the board of directors.
- Arrangements that favored risk takers at the expense of independent risk managers and control personnel. The stature and influence of revenue producers clearly exceeded those of the risk management and control functions.
- Compensation plans that conflicted with the control objectives of the firm. The compensation plans were not linked to the risk and the incentives were skewed to maximize revenues.
- An inadequate and often fragmented infrastructure that hindered effective risk identification and measurement. Inadequate IT infrastructure in the financial firms prevented them to complete integration of data that has resulted from firms' multiple mergers and acquisitions.

3. Recent Developments

A leading independent executive compensation and corporate governance consulting firm, Meridian Compensation Partners LLC conducted a survey (2012 Corporate Governance and Incentive Plan Design Survey, 2012) on 250 large public companies in USA to investigate the executive compensation practices of these companies. Majority of companies surveyed follow a majority voting standard for directors' elections and a declassified Board structure. Another article on CEO Compensation by the same firm (Leckie & Rodda, 2012) points out that most of the shareholders are voting in the support of their Say on Pay vote. According to the authors the Compensation of CEO should be decided on the basis of six factors, company performance, individual performance, alignment with pay decisions for other executives, market data and expected trends, sending message to outsiders on views of performance and sending message to company employees regarding their CEO's performance.
A report published by the Society of Corporate Secretaries and Governance Professionals and Deloitte (2012) covered 16 areas of governance practices. It was found that 84% of the companies reviewed their CEO succession plans. Shareholder engagement has increased and directors met with shareholders more frequently. It was also found that majority of companies has at least 25% women in the board.

SEBI in its consultative paper on Corporate Governance in India (2013) summarized recent policy changes in the Indian corporate governance regulations. It is mandatory to disclose details of the shares pledged by the promoters for listed entities promoted by them. Also, it is compulsory for the Promoter to hold the shares in dematerialized form. The auditor needs to be 'peer reviewed' in order to review a listed entity. The company should disclose its agreements with media companies on its website. Appointment of CFO needs to be approved by the audit committee of a company. Voting results or patterns need to be disclosed by the company on their websites and stock exchanges within 48 hours of the shareholders' meeting. Companies should facilitate e-voting to its shareholders to ensure wider participation. The major recommendations of this paper have been kept in mind while formulating the Corporate Governance Index.

The Companies Bill 2012 was passed in Lok Sabha in December 2012. The Ministry of Corporate Affairs in India decided that the core principles of corporate governance ought to be included in the bill. According the bill, at least one-third of the board should constitute of independent directors. It is mandated that the listed companies need to have a Nomination and Remuneration Committee (Deloitte, 2012). For companies where total number of shareholders, deposit holders, debenture holders exceeds 1000 in a financial year it is compulsory to have a Stakeholders Relationship Committee (SRC). The audit committee needs to appoint a registered valuer who will be responsible for any valuation of property, stocks, shares, debentures, goodwill or other assets, net worth and liabilities etc. The act also directs setting up of National Financial Reporting Authority (NFRA) to take action against the Auditors in the event of a professional misconduct. The act also mandates rotation of auditors and restricts the auditors from providing non-audit services.

An independent body, the Asian Corporate Governance Association (ACGA) published a White Paper on Corporate Governance in India (Asian Corporate Governance Association (ACGA), 2010). The findings suggest that the issue related party transactions needs more attention. This is because Asian companies constitute a part of family or state-controlled groups and can be either listed or unlisted entities. The paper discusses the listing rules of Hong Kong and Singapore in this regard. The study recommends that this issue should be given more weightage in the Clause 49 provisions laid down by SEBI rather than leaving the same on the company law. The paper mentions other irregularities like, issuance of preferential warrants to the promoters of the company, lack of quality and consistency of financial information provided as disclosures and fragmented nature of the auditing industry in India. The paper endorses the legislative and regulatory framework of other Asian countries like, Hong Kong, Singapore Malaysia and China to improve India's corporate governance milieu.

4. Factors for CGI

Clause 49 has been taken as a benchmark for formulating CGI. However, practices that are usually followed by the banks in India have not been included in the Index

4.1 Board of Directors

While formulating the CGI, a minimum and maximum limit has been decided. The rationale behind the same is that a board needs to have sufficient strength of directors for effective corporate governance. At the same time, there should not be too many directors as it would lead wastage of resources, time and efforts of the board. Hence, penalty has been assigned in the CGI for excess number of directors.

According to Clause 49 of SEBI Listing Agreement, one-third of directors should be independent, in case the Chairman of the Board is a non-executive director and half of directors should be independent, if Chairman of the Board is an executive director. Therefore, in the CGI the companies that have more than fifty percent of the directors as independent are assigned higher points.

Number of board meetings is an important parameter for judging the activity level of the board. Clause 49 also specifies that the board would meet for a minimum of four times in a year. Hence, the CGI specifies a minimum and maximum limit.

Post the GFC of 2007-08 many consulting agencies and companies globally have shown their preference towards declassified boards (Meridian Compensation Partners, LLC, 2012). This is because it ensures more accountability of the directors towards issues related to corporate governance.

4.2 Audit Committee

The requirements related to the audit committee, specified in OECD principles and Clause 49 of SEBI Listing Agreement have been listed in CGI. Apart from this, bonus points have been given if all the directors in the committee are independent and if internal auditor reports to the Audit Committee. It has been observed that if the auditor provides services other than the audit service to a company, it leads to conflict of interest (Securities and Exchange Board of India, 2013). Thus, bonus points have been given if auditor in a company provides only audit service.

4.3 Remuneration Committee

Clause 49 lists existence of a remuneration committee as a non-mandatory requirement. Thus, the recommendations of this Clause have been listed in the CGI. Since compensation of CEO has been a contentious

issue since the GFC in 2007-08, companies are setting performance based incentives for CEO. Hence, extra points have been given in CGI for this practice.

4.4 Nomination Committee

Although, Clause 49 is silent on this issue presently, nomination committee is essential for carrying out effective corporate governance in any company (Bank for International Settlements, 2010). Therefore, a few salient points in this regard have been assigned extra points in the CGI.

4.5 Risk Management

Risk Management in financial institutions has been a major reason for collapse of financial markets in the GFC of 2007-08 (Brunnermeier, 2009). The Indian Banking system has been more or less cautious on this factor when compared to other countries. However, globally there has been a need felt to include specific disclosures and practices for risk management in the corporate governance framework.

4.6 Related Party Transactions

Enough has been said about these transactions in academic literature (Mathew & Khanna, 2010) and review by independent bodies (Asian Corporate Governance Association (ACGA), 2010). Bonus points have been assigned if a bank seeks approval from shareholders for divestment decisions, if a majority of the 'minority shareholders' are approving the transaction, or if prior approval from the audit committee has been taken for transactions.

4.7 Disclosures

The disclosure of Indian Banks is quite comprehensive. Thus, a few unique disclosures have been included in the Index to check the level of transparency maintained by the banks. A few material issues have been incorporated in the index like, related party transactions, penalties levied to company for non-compliance, remuneration of each director compared to the median salary of the company, existence of succession planning for CEO, Director or senior managers.

4.8 Policies of the banks

The suggestions from various reports and papers have been incorporated to check if Indian banks are following the best practices and non-mandatory requirements of the corporate governance mandates. Bonus points have been affixed for issues like training provided to board members, evaluation of non-executive directors, separate meeting of independent directors, existence of evaluation system for CEO etc.

Conclusion

The corporate governance Index formulated below thus provides a mechanism to evaluate the adherence of banks to corporate governance principles. There are penalties for certain issues such as excess number of directors in board, independent directors holding more than nine years' tenure in the bank etc. Also, the index assigns bonus points for banks that go beyond the mandatory requirements as laid down by Companies Act and Clause 49 of Listing Agreement. These bonuses have been decided basis the review of current practices being followed by the companies globally and the diagnosis of the gaps currently prevailing in the financial system.

Table 1: Corporate Governance Index for Indian Banks

	Sub Elements	***Points***
	Board of Directors	
No. of Directors	Board consists of 8 *to 12 members*	3
	Board consists of *more than 12 members*	2
Chairman	Chairman of the Board is a non-executive directors	5
Director Independence	Proportion of independent directors *is less than 33.33%*	0
	Proportion of independent directors *is equal to 33.33% and less than 50%*	1
	Proportion of independent directors *is equal to 50%*	3
	Proportion of independent directors *is greater than 50%.*	5
CEO Duality	Chairman is an independent director (and separate from CEO)	5
Board Meetings	Number of meetings *greater than or equal to* 6	4
	Number of meetings *greater than or equal to* 4	1
	Number of meetings *greater than or equal to* 12	-1
Board Structure	Declassified Board	5
	Audit Committee	
Director Independence	All directors are independent	3
	At least 3 directors in Audit Committee are independent (two-thirds must be independent)	1

Committee Meetings	Audit committee exists & meets at least 4 times a year	1
	Independent members of audit committee meet separately as well	1
Allied Services by Auditor	Auditor provides only audit services	5
Reporting Mechanism	Internal auditors report directly to the audit committee	3
	Remuneration Committee	
	Remuneration Committee exists	1
Committee Meetings	Remuneration Committee meets at least 2 times a year	1
Director Independence	At least 3 directors in remuneration Committee are independent	3
Chairman Independence	Chairman of Remuneration Committee is independent	3
Criteria for CEO Incentives	Performance Based Incentive of CEOs	5
	Nomination Committee	
Committee Meetings	Nomination Committee meets at least 2 times a year	1
Director Independence	All members are independent	3
	All are not independent, but Chairman is independent	2
	Risk Management	
Credit Allocation	Credit allocation procedures exist	1
Lending Exposure	Bank does not have significant lending exposure to a single client	5
Risk Management Initiative	Risk Management Plan exists	5
	Related Party Transactions	
Divestment of subsidiaries	Approval required by shareholders for divestment of major subsidiaries	5
Minority Shareholders' Approval	Any RPT approved by majority of the minority shareholders	5
Audit Committee's Approval	RPTs approved by audit committee before the transaction takes place	5
	Disclosures	
Related Party Transactions	Related Party Transactions disclosed	3
Non-Compliance	Details of non-compliance by the company and penalties	5
Relative Remuneration of Directors	Ratio of Remuneration of each director to median employees' remuneration	5
Succession Planning	Disclosure of Succession Planning	5
	Other Policies	
Training	Board members are trained	2
Performance Evaluation	Performance of non-executive directors evaluated	2
Whistle Blower Policy	Whistle Blower Policy exists & communicated	2
Tenure of Independent Director	Independent directors serving more than nine years' tenure in the board till date	-2
Performance Evaluation	Performance of CEO evaluated	2
Multiple Directorship	Director(s) in more than 6 companies	-2
Peer Evaluation	Peer evaluation of Board Members	5
Meetings	Separate meetings of Independent Directors	5
Lead Independent Director	Appointment of Lead Independent Director	5
Managerial Remuneration	Approval of minority shareholders required if managerial remuneration is above a certain limit	5

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