ABSTRACT

Financial system has an important role in the daily life of people and ensures the prosperity and economic development of the country. Corporate governance framework helps to integrate the local financial system with the global financial market in the liberalized economic environment. The governance framework should ensure the strategic guidance of the entity, oversight of management activities by the board and board’s accountability towards the entity, shareholders and other stakeholders. The governance framework strengthens shareholders rights, minimize transaction cost and cost of capital and leads to development of capital market. Capital market and corporate sector cannot develop with weak minority shareholders, inadequate disclosures and reporting practices, non-compliance of the laws, rules, regulations and lack of independent oversight of the directors. To rely on effective corporate governance and build a public confidence in the banking industry, strong enforcement mechanism of the legal and regulatory framework is a must. The lack of transparency and disclosure has been considered as one of the major causes of the corporate scandals and governance failures in recent years around the globe that adversely affecting public confidence in the reliability of disclosure practices. Nepalese financial sector has yet to establish full good governance practices to become the more reliable and competitive sector of the economy.

Keywords: Corporate Governance; OECD; Basel Committee; BAFIA; Nepal Rastra Bank

INTRODUCTION

Corporate governance refers to the management and control of the company. The corporate governance mechanism tries to reduce or eliminate the problems between the principal-agent. The principal delegates the decisive rights to the manager to act in the best interest of principal. As a result of this separation between the two parties, governance mechanism is implemented to assist in aligning the functions of managers with shareholders. The Board plays important role in corporate governance mechanism.

The traditional approach of corporate governance in the financial sector often involved the regulator or supervisor relying on statutory authority to promote the interests of shareholders, depositors, creditors and other stakeholders. Policy makers and regulators in the financial sector are recognizing the positive impact of a corporate governance regime in safeguarding the interests of a wide range of stakeholders. There has been growing interest in the corporate governance practices of modern corporations after failures of high profile US companies after circa 2001.

Many researchers reported that corporate governance principles are more important for financial sectors due to the special nature of business which is more challenging to operate and survive in long-run. It has a distinct obligations and responsibilities towards the depositors, creditors and other large number of stakeholders. The multifaceted role of banking industry in the economic development of the country has attracted much more regulatory attention to impose corporate governance norms and
address the risks faced by banking institutions. The important role of the private sector including banking in economic development and job creation has become more aggressive worldwide since past few years. If a single financial institution fails, it leads to bust the whole financial system as well as the negative impact on economic environment of the country.

Corporate governance in banking institutions is considered by the Basle Committee on Banking Supervision of the Bank for International Settlements (BIS) to be a basic element in the stability of financial markets. The regulatory framework in Nepal has involved laws, rules and directives together assimilate the core elements of corporate governance for Bank and Financial Institutions (BFIs).

LITERATURE REVIEW: EMPIRICAL DISCUSSIONS

The modern concept of corporate governance, the two buzz words have been commonly used in the English-speaking world since the 1990s due to the series of failures of big corporate houses in western world as a top concern both for the international business community and financial institutions.

The issue of corporate governance arises from the agency theory that clearly defines the ownership of a corporate body is separated from its management and control (Berle & Means, 1932). A corporate governance framework should protect shareholders’ right, such as voting right, right to elect board member, right to get relevant information, interact and communicate with the management, equitable treatment of all shareholders (Tricker, 1984).

Adhikari, (2008), claimed that corporate governance is a system of leadership and control of the company and its foreseeable sustainability. According to Sapkota (2008), corporate governance framework ensures to establish the strategic objectives of the company and the means to attain and monitor these objectives. Corporate governance in banking industry is more important than other industries, particularly in less-developed countries because economic development and growth is dependent to a large extent on well-functioning, stable and soundly managed banking system (Islam, et.al. 2009).

Banking business is highly regulated businesses and oversight by the government and regulator. Banks are the important factors of economic reforms and development of the country (Gorkhali, 2010). Alexander (2004), reported that best corporate governance practices will enable banks to get easy access in the capital market and decrease the cost of capital and protect the rights of minority shareholders including foreign shareholders. Kharouf, (2000), argued that an entity is affected by the relationship among the participants in the system of governance. Controlling shareholders can significantly influence corporate behavior. However, all shareholders should able to get effective redress for violation of their rights and prohibits insider trading and abusive dealing in their personal interests.

According to Arun and Turner (2004), corporate governance of banks in developing economies is important for several reasons. First, banks have dominant position in developing-economy financial systems and are important engines of economic growth. Second, banks in developing economies are typically the most important source of finance for the majority of firms. Third, banks in developing countries are usually the main depository for the economy’s savings. Fourth, many developing economies have recently liberalized their banking systems through privatization/disinvestments and reducing the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

Poor corporate governance of banks can drive the market to lose confidence in the ability of a bank then it leads to economic crisis in a country and invite systemic risk (García-Marco & Robles-Fernández, 2008). In contrast, good corporate governance strengthens property rights, minimise transaction cost and the cost of capital, and leads to capital market development (Claessens & Fan, 2002). Corporate Governance aims to minimize the chances of corruption, malpractices, financial frauds and misconduct of management (Ubha, 2007).
Disclosure and transparency are key pillars of a corporate governance framework in banking industry because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of (Katrodia, 2010). Bank, being the responsible corporate citizen understands its commitments towards stakeholders and society at large. The strategies of Bank includes to nurture and grow a sustainable business far beyond profit making or being the best and seek to create a value for a variety of stakeholders including shareholders, employees, customers, creditors, communities and the natural environment (CBC, Annual Report, 2010).

The high concentration of corporate ownership structure and dominance of family business in corporate affairs have become major constraints in exercising good corporate governance in Nepalese corporate sector (Gorkhali, 2010). According to Armstrong & Spellman (2009), shareholders should act as owners of the corporations, it is only through corporate governance-abiding by the letter, and the spirit of regime in which the interests of the owners are a director’s reliable compact-that trust and confidence can be restored.

According to Stiglitz, J. (2009), Banks have the unique ability to attract funding in the form of deposits that are fully insured up to a limit and thus insensitive to risk. Moreover, unhealthy banks are taken over by regulators instead of having to face bankruptcy in public courts. Assets are subsequently sold to another institution or in case of multiple bidders, to the highest bidder.

Corporate governance is one of the key factors that determine the health of financial system and its ability to survive economic shocks (Bollard, 2003). The importance of corporate governance of financial institutions such as banks remains ever crucial that banks will operate in a safe and sound manner, and will comply with applicable laws and regulations while protecting the interests of depositors (Wilson, 2006).

Corporate governance reforms are of great significance for developing countries like Nepal, to gain a sustained effort to attract Foreign Direct Investment and Foreign Portfolio Management, and to mobilize greater saving through capital market (Sapkota, 2008). The implementation of the governance principles should be proportionate to the size complexity, structure, economic significance, and risk profile of the bank and the group to which it belongs (Basel, 2006).

OBJECTIVE OF THE STUDY AND HYPOTHESIS

Based on the above background, the objectives of the study is to examine the legal and regulatory provisions in relation to corporate governance framework in banking institutions with reference to OECD principles of corporate governance and Basel Committee corporate governance framework in the context of Nepalese commercial banks and their application status.

Descriptive study methodology has been adopted to become familiar with the elements of corporate governance through available literature in the banking industry. This study has hypothesized that strong corporate governance framework built on the appropriate application of legal, regulatory and best practices.

OECD Principles of Corporate Governance

OECD (1999) defines corporate governance as “a set of relationships between a company’s management, board, shareholders and other stakeholders. It also provides the structure through which objectives of the company are set, and the means of attaining those objectives and monitoring performance. Islam (2005), observed that, corporate governance framework includes inter alia, board composition, relationship between the Board and management, internal control mechanisms, and independent audit committee. These four principles are similar with the OECD principles, which are (i) compliance with all regulatory requirements (ii) equitable treatment of all stakeholders such as suppliers, employees, consumers (iii) full and fair disclosure of all material information with particular emphasis on accurate presentation of financial information and (iv) respect for norms of business ethics and social responsibility.
On the basis of above concepts, definition and review of literature, the corporate governance frameworks are derived from OECD’s principles of corporate governance. OECD’s principles are generally taken as basis to frame the governance system all over the world, which are briefly summarized hereunder.

1. Corporate governance framework complies with all the laws, rules and regulatory requirements.
2. Corporate governance framework recognizes rights, protects and facilitates the exercise of shareholders’ rights.
3. Corporate governance framework recognizes the equitable treatment of all the shareholders including minority and foreign shareholders.
4. Corporate governance framework should establish a performance enhancement system for active participation of stakeholders.
5. Corporate governance framework should ensure the availability of relevant information.
6. Corporate governance framework ensures transparency, accountability and professionalism in the management system.
7. Corporate governance framework should ensure the respect for norms of business ethics and responsibilities of Board.

Basel Committee Corporate Governance Framework

For the critical importance of Bank’s governance system, Basel Committee on Banking Supervision published a guidance paper in 1999 to assist banking supervisors in promoting and adoption of sound corporate governance practices. The guidance drew from OECD principles of corporate governance to assist member countries to improve corporate governance in their jurisdictions. Basel Committee's corporate governance framework provides guidance to financial institutions and financial market regulators. The Basel Committee’s document, “principles for enhancing corporate governance” set out best practice for banking organizations. Implementation of provisions of Basel II in banking sector forms important part of good corporate governance. The key areas of the principles from the banking and financial industry perspective are highlighted hereunder.

1. **Set corporate strategies and values to be communicated in the Banking industry:** The Board should set corporate strategies that will direct the ongoing activities of the bank in which they operate and includes approving and overseeing the implementation of the bank’s risk strategy. The Board should also set the vision, mission, corporate objectives and code of conduct for the board members, senior management and staffs.

2. **Define the responsibility and accountability of the Board:** Corporate governance framework should ensure a clear definition of the authority and responsibilities of the Board members and senior management. Senior management is responsible towards the board and board towards the company and shareholders.

3. **Ensure the Board members are qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank and are not undue influence from management or outside concerns:** The board of directors is responsible for the operations and financial soundness of the Bank. Board members should have adequate knowledge and experience relevant to each of the financial activities of the bank and able to effective oversight of the activities. The Board, may oversight the activities through the various committees that normally have in the Banks but not limited to (i) Audit Committee (ii) Risk Management Committee (iii) Compensation Committee (iv) Nomination Committee
4. The Board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions: The auditors’ role is importance for proper maintenance of the corporate governance system. The effectiveness of the board and senior management can be enhanced by the importance of the audit process, independency of auditors, addressing the findings of auditors in time and evaluate the effectiveness of internal controls system.

5. The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives, strategy and control environment: The board should approve the compensation of senior management, other key personnel, and ensure that such compensation is consistent with the bank’s culture, objectives and strategy. This will help to ensure that senior management and other key personnel will be encouraged to act in the best interests of the bank.

6. The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency know-your structure: Transparency and governance system are relatively important two elements in corporate governance. Normally the disclosure practices is desirable in the areas such as accounting rules, management performance and discussion, risk management, related parties transactions and other relevant information including legal and regulatory requirements.

Corporate Governance Practices in Nepalese Banks

From review of literature and corporate governance principles from the banking perspectives it is clear that corporate governance ensures transparency, accountability and professionalism in the financial system that enhances the credibility and acceptability to the shareholders, employees, present and potential investors, customers, lenders, governments and general public. Since Banks deal in public money and public confidence is of outmost importance (Gorkhal, 2010).

Corporate governance should be strengthen through setting the clear strategies, well-defined organizational structure to implement the strategic, transparent reporting system in an ethical manner and controlled environment (Kharouf, 2000). According to Poudel & Hovey (2011), corporate governance is equally significance to all types of corporate entities. The 1997-1998 economic crises in the Asian countries highlighted the importance of corporate governance. In developing countries such as Nepal, a good governance of Banks is crucial for the survival of its economy.

In Nepalese context, more of the corporate governance practices are expected to evolve under the regulatory requirements of the Nepal Rastra Bank rather than other laws and rules. Therefore, in this section, history and general environment of banking institutions in Nepal and applications of corporate governance with reference to OECD Principles of Corporate Governance and Basel Committee on Banking Supervision framework are discussed.

History of Banking and Financial Business in Nepal

The history of financial system of Nepal has begun since 1937 with the establishment of Nepal Bank Ltd. as the first commercial bank of Nepal with joint ownership of government and general public. Nepal Rastra Bank (NRB), the Central Bank was established in 1956 after 19 years since the establishment of the first commercial bank. A decade after the establishment of NRB, Rastriya Banijya Bank, another commercial bank, an undertaking of Government of Nepal was established. For the banking development, 1980s saw a major structural change in financial sector policies, regulations and institutional developments with the liberal policy of Government. Government emphasized the role of the private sector for the investment in the financial sector. With the adoption of the financial sector liberalization by the government in 1980’s opened the door for foreign Banks to open joint venture Banks in Nepal. As a result of the liberalized economic policy of the government in the financial sector, numbers of banking and non-banking financial institutions came into picture.
Nepal Arab Bank Limited, the first foreign joint venture bank started operations in July 1984. The bank was established with 50 percent equity participation of a foreign bank. Establishment of this joint venture bank brought foreign investment, modern banking system and technical skills in the banking industry. Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. Himalayan Bank Limited and Nepal SBI Bank Limited were established in 1993 and Nepal Bangladesh Bank Limited and Everest Bank Limited in 1994. All of them were established as joint venture commercial banks.

Nepal witnessed tremendous increment in number of financial institutions within two decades of starting of financial sector reform. Nepalese banking system has now a wide geographic reach and institutional diversification. As on July 2013, altogether 253 banks and financial institutions licensed by NRB are in operation. Out of them, 31 are Commercial Banks, 86 are Development Banks, 59 are Finance Companies, 31 are Micro-credit Development Banks, 15 are Saving and Credit Co-operatives and 31 are NGOs. Total banks branches are 1,486 with the population of 8,443 per branch (NRB Annual Report, 2013).

**Legal and Regulatory Environment in Nepalese Banks**

Nepalese banks are operated by the Bank and Financial Institutions Act (BAFIA) 2006, Companies Act 2006 and regulated by the Nepal Rastra Bank. After the operations of the joint venture commercial banks in Nepal since 1984, they brought modern banking system and exercise to establish the good governance practices in Nepalese financial system. In considering the general banking environment in Nepal, it is important to emphasize the banking laws, commercial laws and regulatory frameworks. According to Kharouf, (2000), supervisory rules, regulations and the influence of international regulatory authorities, such as the Bank for International Settlements, on local regulations are other elements that lead to differences in governance. Adhikari, (2013), reported that financial reporting standards issued by the professional bodies will affect the local practices and the development of adequate laws and regulations. Accordingly, application of accounting standards and auditing practices impact the environment of the company.

Another contributing factor is the level of exposure of the banking institutions to international regulations. The banks with a foreign ownership are more likely to have an advanced level of corporate governance than those with limited international exposure. Another important common dimension that is relevant to corporate governance is the strong family control of ownership, boards of directors and management (Mundul, 2005).

Moreover, Nepalese financial institutions in general are limited in their traditional banking activities. This limitation may also imply still weak corporate governance in general. In spite of these issues, most Nepalese banks are small in size compared to the major financial players in the international markets. There are thirty-one commercial banks operating banking business in Nepal as on July 2013 (NRB Report, 2013). Commercial banks dominate the overall financial sector with limited role of non-bank financial institutions and the capital market. The banking sector alone accounts for a substantial share of assets of the financial system. The financial system is dominated by the commercial banks on the share of the balance sheet components of the overall financial system. Commercial Bank occupied 78.2 percent of total assets/liabilities, 81.2 percent total deposits, and total capital fund NRs. 94,661 million/USD 985 million (NRB Report, 2013).

Nepalese banks are trying to continue to innovate new product and global networking of the banking environment with implementation of strong corporate governance framework. Nepal Rastra Bank, as the regulator, has the responsibility to supervise the nature of corporate governance practices in the banking sector. Government of Nepal and Nepal Rastra Bank has continued the financial sector reform program and emphasizes the maintenance of good governance practices in financial sector that create the environment to ensure the flow of foreign investment. The major recommendations of the OECD and Basel Committee on Banking Supervision are being adopted by the Nepalese banks in order to safeguard the stability of the economy and financial system.
Application Status of OECD and Basel Governance Framework

After the Asian financial crisis in 1997-98, to improve the corporate governance practices has become a major challenge for the Nepal Rastra Bank, the Central Bank of Nepal, due to the number of cases of failure, fraud and malpractices as well as liquidity crises reported one after another in the Nepalese financial sector. Since then, numbers of laws, rules and regulatory reforms have been implemented to strengthen governance system including requiring the establishment of board committees, defining board’s role and responsibilities, maintenance of the board’s independence, provision of professional director in the board, transparent board governance system, public disclosure requirements etc.

Poudel and Hovey, (2013) reported that, Nepal Rastra Bank reported severe lapses in corporate governance in most of the banks, despite issuing directives to strengthen corporate governance in 2005, the results were not improved. Section 5 of the Nepal Rastra Bank’s Unified Directives No. 6, Banks and Financial Institutions (BFIs) are only allowed to constitute Audit, Risk Management and Human Resource Management committees. However, most of the banks formed only Audit and Risk management committee which are reported in their annual report. Therefore, OECD principles and recommendations of Basel Committee on Banking Supervision for corporate governance are expected to have the following impact on the Nepalese banking industry:

(i) **Stated Strategic Objectives and Risk Management:** Nepalese banking industry still to move towards setting of designed conduct, core values and overall banking strategies. However, due to the relatively small size of the assets of the banks, it is observed from published annual reports that very few banks are able to implement such strategies.

(ii) **Clear Lines of Authority and Responsibility:** There must be a clear definition of the authority and responsibilities of the Board members and senior management. Senior management is responsible to the board for the performance of the bank. The unclear authority and responsibility makes difficult to work and the role and responsibilities should be defined in order to implement strategic objective in smooth running of day-to-day banking business.

(iii) **Ensuring the Adequate Qualifications of the Members of the Board:** This is an arbitrary issue about the qualification of Board members in Nepalese banking industry. Even though, certain qualification has been prescribed in BAFIA 2006, which may not adequate to run the banking business. Regarding ownership structure of most of the Nepalese Banks and representation in the Board, there must be adequate number of Non-executive and independent board members having sound banking knowledge to operate the banking business. Adhikari (2006), claimed that the quality of professional directors going by the Nepal Rastra Bank’s first list and weigh heavily on the corporate board rooms instead of providing the desired professional expertise and independence necessary for a balanced board to protect the interest of all the stakeholders.

(iv) **Oversight the Activities of the Senior Management:** Board of directors is responsible for the operations and financial soundness of the Bank. The board must get the relevant information on timely basis to evaluate the performance of the management. Board, may oversight the activities through various committees that normally have in the Banking Industries. However, based on practice and regulatory requirement only Risk management committee and Audit committee are functioning to assist the Board to oversight the management activities in banking industry in Nepal.

(v) **The Role of Internal, External Auditors and Internal Control:** The primary responsibility of the maintenance of internal control system rest with the bank management, however independent auditors are also the important player in the corporate governance system. The internal control systems are evaluated by the internal auditors and their functions are oversight by external auditors too. However, based on practice there is no system of separate reporting about the evaluation and effectiveness of the internal control system of the banks.

(vi) **Compensation with Objectives and Ethical Environment:** The issue of the amount of compensation and the bonus has always been of controversy and importance among members of the
Board and senior management. The importance of this matter arises from the impact of compensation granting method on the conflict of interests between the company and the managers, the future performance and consequently profit making of the company. Therefore, it is crucial to consider the long-term goals and strategy of the company for granting the compensation (Mashayekhi et.al, 2014).

According to Sapkota (2008), Nepalese financial institutions do not have self-managed codes of conduct to disclosed details of facilities provided to board members and senior executives; however, there is mandatory provision of Company Act, 2006 to disclose the managerial expenses in the annual report. However, based on practice, the Board determines the remuneration and facilities to the chief executives in absence of remuneration committee

(vii) Transparency and Disclosure System: The Nepalese banking industry, in recent years has practiced to disclose the material matters including regulatory requirements in line with the recommendations of the Basel Committee. Most of the banks have disclosed very few items of accounting standards compliance notes observed in their annual reports (Adhikari, 2013). However, commercial banks in Nepal, are now required to disclosed profitability ratios like return on assets, earning per share which are important ratios to judge the performance and strengthening corporate governance of Banks (Adhikari, 2013). According to Sapkota (2008), disclosure system and transparency level of Nepalese financial institutions is not in well-built condition. The top-level management is reluctant to disclose many friendly information, if disclose, that reduces the gap between management and the other stakeholders.

CONCLUSION

Corporate governance frameworks in Nepalese banks are designed on the premise of the provisions of Bank and Financial Institutions Act 2006, Companies Act 2006 and NRB Directive-No.6 on Good Corporate Governance. Regulation of Banks and Financial Institutions (BFIs) and supervision of application of corporate governance in BFIs also the responsibility of the Nepal Rastra Bank, the Central bank of Nepal. Numbers of positive signs for improvement of governance system in Nepalese financial sector are being seen in recent years in comparison with other corporate sector due to regulatory requirement as well as on-site and off-site supervision by the Nepal Rastra Bank.

Despite of numbers of improvement of governance practices seen in the Nepalese Banks, to strengthen the governance system, the Board should move forward to set the vision, mission, core values, strategies and well-designed organizational structure. The laws and regulation needs reform to come with more stringent governance system including properly defining authority and responsibilities of board directors, qualification of directors, board governance system, oversight function of independent director, transparent reporting and disclosures practices in an ethical manner. There are several lapses in corporate governance in most of the banks, despite issuing directives to strengthen corporate governance. Further, financial institutions do not have self-managed codes of conduct to disclosed board decisions, financial situations and facilities provided to board members and executives.

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