CORPORATE GOVERNANCE & IT'S IMPACT ON PERFORMANCE OF THE INDIAN BANKING SECTOR – A STUDY

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Abstract: The impact of banks' organization structure on performance and corporate governance practices has been discussed for a number of years, mainly in developed countries such as UK and US. This paper chooses to address above-mentioned issue in Indian context. It investigates two category of banks namely government banks and private banks. This paper adopts the Tobin's Q, and Return on Capital Employed (ROCE) as bank performance indicators. The following board governance variables are used such as Board Committees, Board Directors, CEO as a chairman, Board meetings, and Women Executive and Executive-Director ratio. Multiple regression analysis results show that board governance variables like board committees, board directors and women director are statistically significant to performance for banks where government has considerable stake. In addition, government banks are older and also have better market valuation than private banks.

Keywords: Indian Domestic Banks, Bank Governance, Tobin's Q, and ROCE.

Introduction: The liberalization reforms initiated by the Indian government during last decade have considerable impact on the Indian financial sector. Prior to 1991, Indian banking sector was under control of Indian government with exception of 22 private sector banks and few foreign banks (source: RBI). Since 1991, the Indian financial system moving from a unilateral administered sector to market driven system. After the economic crisis, there have been a number of initiatives to implement governance and disclosures practices in the Indian banking sector. In the recent past, overall corporate governance in Indian banks has improved steadily. Internationally, the influence of board governance on performance has been discussed for a number of years, but it is relatively new to Indian scenario, where corporate governance norms are implemented in the recent past. Board governance is a subset of corporate governance in determining financial performance of the bank.

It is evident from the research conducted by Fama and Jensen (1983); they argued board of directors is important in the corporate governance system. According to Mizruchi (1983, P, 433) The Company board is a powerful center to have ultimate control over company affairs. It is true in the most of the cases, when CEO of the company willing to accept importance of board. Walsh and Seward (1990) found board plays a crucial role as an internal control mechanism. The literatures relating to company board identifies two broad categories of control mechanism namely internal and external.

The internal control mechanism is employed through board governance, equity ownership, compensation etc, whereas institutional investors influence, legal protection for individual investors, and active capital market for corporate control represent external control mechanism. This paper mainly examines internal control mechanism influence on firm performance. The variables selected for internal control mechanism are CEO as board chairman, Outsider ratio in the board, Board size, and number of board meetings held. Another important factor determines firm performance is ownership pattern. Ownership structure has been extensively discussed for long time among researchers, academicians, and business practioners. Berla and Means (1932) found relationship between ownership and management

towards firm performance. They argued that firm performance is increased when management is separated from ownership. Jensen and Meckling (1976) used principal – agent conflict to explain divergence of thinking in firm related issues between owners and management of firm. Fama (1980), and Fama and Jensen (1983) suggested that these agency problems could be solved through systematic dispersion of firm's stake. Recently several studies have examined bank structure influence on financial performance. This paper describes bank structure in three ways namely government banks, private banks and foreign banks. The reason for three way classifications of banks, government banks tend to have different approaches to control, board size, board chairman, board meeting, outsider to be board etc, as compared to private and foreign banks. This paper investigates whether board governance is positively related to performance in government banks or in private banks.

Apart from above mentioned variables, this paper uses Tobin's Q and Return on Capital Employed (ROCE) as bank performance indicators. Most of the corporate governance literatures have used these variables as proxy for the bank performance. The present study chooses to address the effectiveness of one set of corporate governance mechanisms (board governance) influence on bank performance. This paper is organized in the following way. The following section reviews the literature on corporate governance and also presents board governance (Board committees, Board directors, Women executive, CEO as a chairman, Board meetings, and Director ratio), and firm performance indicators (Tobin's Q and Return on Capital Employed). The section thereafter presents data sample and description of variables followed by a section that describes methodology. The section, before last section explains analysis of data. In the last section has finding of the study.

Brief Review of the Available Literature: The recent corporate failures world over has reinforced the importance of corporate governance. It is important for investors to differentiate corporate on the basis of governance principles in order to find out good from the bad. Undoubtbly, corporate governance is need of the hour. Corporate governance is a control mechanism through which supplier of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishney, 1997). Corporate governance is concerned with managing the relationship among various corporate stakeholders (Malek Lashgari, 2004). In India, Confederation of Indian Industry (CII) has stated that "C.G deals with laws, procedure, practices, and implicit rules that determine a company's ability to take managerial decisions vis-à-vis its claimants in particular, its shareholders, creditors…There is a global consensus about the objective of good corporate governance: maximizing shareholders value", Subsequently Security and Exchange Board of India (SEBI) has come out with report on C.G.It stated that "…. fundamental objectives of corporate governance is the enhancement of shareholders value keeping in view the interests of other shareholders….". The major contribution of corporate governance is enhancing operating performance of firms, and also preventing the fraud (Yeh, Lee, and Ko, 2002). Black, Jang, and Kan (2002) found that companies with better corporate governance have better financial performance than companies with poor corporate governance. It is well supported by Jensen and Meckling, (1976) and Fama and Jensen, (1983). They found good corporate governance really helps owner's to exert control over corporate affairs. Corporate governance mechanisms give commanding position to the owners to manage corporate insiders and managers.

Bank Governance: The board of directors is the ultimate governing body on bank affairs. The main task of bank board is to monitor and control management on behalf of owners. The board of director is top executive unit of a company and is charged with the responsibility of supervising operations of the company's management (Hsiang-Tsai Chiang, 2005). Normally, board performs variety of functions such as monitoring and controlling management, approving dividend decisions, deciding business policies, and facilitating development and implementations of corporate strategy. Boards are required to deliberate on the strategic agenda of the company. Boards plays major role in corporate governance in the bank.

Effectiveness of the board depends on the board directors. According to company's act 1956, board size is minimum of three directors in case of public limited companies and two in case of private limited companies. Jensen (1993) found a board should have maximum of seven or eight members to function

effectively. There is no clear-cut evidence that smaller board performs effectively than larger board. In a smaller board, members are more likely to agree on a particular outcome (Lange et.al, 2000). In contrast to this view, larger boards may act as an increased pool of expertise and a better ability to form reasonable judgment (Goodstein, Gautam& Bocker, 1994). It is hard to arrive optimum number of directors for the board. Hsiang-Tsai chiang, (2005) found insignificant relationship between board structure and firm performance. Ingrid Bonn (2004) also found board size never leads to firm performance. He argued that it is not board size, per se, that was important for firm performance but rather composition of the boards in terms of the ratios of outside directors. According to SEBI listing clause 49, not less than 50 % of the total number of directors should be an independent non-executive director. In case CEO as a chairman of the boards, at least half of board should have independent directors. Lang.et.al (1999) found inside directors generally have a greater understanding of the company's operations. However, outside directors are more professional and are in a better position to exert control over management. Fama (1980) stated that independent directors are better in managing and monitoring management self interest and opportunism. Past research have shown mixed results on performance influence of outside versus inside directors on firm performance. Most of the researches have support outside board members influence on firm performance Pearce and Zahra (1992) argued there is high degree of association between executive ratio and firm performance. It is well supported by Mahajan and Sharma (1985), They found board with high proportion of independent directors works effectively. It is common practice that CEO of the bank may act as chairman of the board of directors. There is contrasting opinion among researcher regarding CEO of the firm concurrently act as chairman of the board. One set of researchers argued against it, just because board effectiveness may come down drastically due to lack of independence. On the other hand, CEO can give ultimate direction to the boards regarding company's future strategy and able to run in a proper way. Past research in the direction provide support for both argument. Hsiang-Tsai (2005) found negatively related to performance if CEO assumes role of chairman of the board. The same results provided by Fama and Jensen (1996). On the other hand, Anderson and Anthony (1986) argued that it may reduce conflict between CEO and board of directors, and that leads to effective functioning of board. Board meeting is an important element in the board governance. According to SEBI, listing agreement 49, minimum four board meetings must be held in a year with time gap not exceeding 4 months between two meetings. Confederation of Indian Industry code on corporate governance has recommended minimum of six meetings in a year. Each meeting should hold at an interval of every two months. The logic behind this exercise is to examine and question the executive actions. Executives are held responsible for the way they conduct the business in the board meetings. There is relationship exists between number of board meetings held and firm performance.

It is understood that government banks have a long-term orientation, which encourage a strategic approach. Government banks differ from other firms on day-to-day matters. In addition, government controlled banks rarely given up management control to managers and they are expert at retaining ownership. Past literature showed that government ownership is positively significant to profitability, but it is less significant to market returns. According to Narendar et al (2005), foreign banks in Indian put up superior performance than other domestic banks. Allen et al (2005) argued that state owned banks have poor long-term performance for the sample banks from Argentina, but these banks dramatically improved during privatization of banks. The bank controlling rights and cash flow rights are having positive correlations (La Porta et al, 1998). They further argued that state owned banks is a common feature in many developing countries (La Porta et al, 2000) The reason for wide spread of state owned banks in emerging countries that the government credibility is more or less depend on stable financial sectors in the country (Arun and Turner, 2002). In India, the government has taken appropriate steps to implement good corporate governance practices in Indian banks. Results of that, the public sector banks have disinvested infavour of Indian public. But, there is literature, which account negative impact of corporate governance on bank performance. There is a negative relationship between governance intervention and performance for Spanish banks (Rafel et al 2004). The empirical evidence concerning the possible association of bank performance and corporate governance is extremely limited. This paper can be uniquely placed as one of few papers emerged in India that try to explain public sector banks influence on board governance practices.

Hypotheses: With reference to review of literature of corporate governance, and different types of banks, this paper develops the following hypotheses for study.

H1: Public sector banks are older and have better valuation than private sector banks
H2: Corporate governance practices have significantly influence the performance in the Indian domestic banks
H3: Public sector banks' corporate governance practices significantly different than private sector banks.

Data Sample And Description of Variables: The data that have been used in this paper has been obtained from PROWESS, a financial database of Center for Monitoring Indian Economy (CMIE) and the website of Reserve Bank of India (RBI). The initial data sample collected as on 31st march 2005. The same sample is divided into three sets namely government banks, private banks and foreign banks. Hence, The final sample consisted of 89 banks, in which public sector has 28 banks, the private sector consists of 30 and the remaining 31 banks belong to foreign banks (Source: RBI). In India, the implementation of corporate governance practices is directly linked with Security Exchange Board India (SEBI) under clause 49 listing agreement. According to SEBI, the corporate governance practices applicable only to banks that are listed in the Indian stock exchanges. At present, only 41 banks listed in the Indian stock markets, where 21 banks belong to public sector and the remaining 20 banks in the private sector category. The final sample consists of only 41 banks

Bank Performance Indicators; A bank performance indicator consists of two variables namely Tobin's Q, and Return on Capital Employed. Most of the past literature on financial institutions has used accounting measure as a proxy for performance. In this paper, both accounting and market valuation measure are used to account corporate governance practices intervention.

Tobin's Q: Tobin's Q is a very widely used measure of corporate performance**.** It is defined as the ratio of market value of the firm to replacement value of the assets. Interestingly, original definition of Q has few practical limitations such as availability of timely and accurate Q date. It is understood that even computational procedure also is difficult to employ. Kee and Prulti (1994) found approximation for original Q value and it is computed as book value of debt plus market value of equity plus book value of preference shares over book value of total asset.

Return on Capital Employed (ROCE): The profitability of an organization is measured through ROCE. It indicates the effectiveness and efficiency of an organization in generating earnings. It is calculated by dividing earnings before interest and taxes (EBIT) by capital employed.

Independent Variables: ***Board Directors***: It is defined as the number of directors both executive and non-executive directors in the bank, it is denoted by FBd. Director Ratio: It is defined as the ratio of executive director to non-executive directors on the board, it is denoted by FDr. CEO as Chairman of the Board: This measure uses the dummy coded variable. If bank has CEO as a chairman of the board then it is coded as (1) and if not, it is coded as (0). It is denoted by F Ceo. Board Meetings: Total number of board meetings held in a year, it is denoted by F Bm. Board Committees: it measure number of committees in the banks, it is denoted by F Bc. Women executive: it is dummy coded variable where bank employs women executive in the board, it is coded as (1) or else, it is coded (0). This measure denotes by F We. In addition, the bank dummy is used to account the corporate governance practices differences between public and private sector banks. This bank dummy is coded by (1), if it is public sector bank, or else, it is coded as (0). The bank dummy is denoted by F Bank dummy.

Control Variables: The present research employs the following control variable for the study:
Log Age: It is a difference between the current year and the year in which the bank was incorporated. Age is measured by the logarithm of the number of years since the banks were set up. Due to effect of learning curve and survival bias, older banks are largely to be more efficient than the younger banks. It is used in firm value related studies (Ang, Cole, And Lin, 2000). It is denoted by Fage

Methodology for the Study: Corporate governance influence on bank performance is measured through multiple regression analysis. Multiple regression analysis is widely used multivariate technique, which uses to predict dependent variables from known independent variables. In this paper, multiple regression analysis is used to find out independent variables influence on dependent variables after controlling firm age. There are two multiple regression analysis model is constructed. The first model is based on all the banks listed in the stock markets. The second model uses a bank dummy to account the public sector banks' corporate governance practices influence on performance over private sector banks. Pearson correlation coefficient is also used to find out multicollinearity problem among independent variables. The correlation matrices determine whether multicollinearity problem is present in the independent variables or not. Correlation coefficient value is more than 0.80, where the multicollinearity problem exists (Ingrid Bonn, 2004). In addition, the descriptive statistics has employed to analyse the relationship between banks age and profitability. In equation form, multiple regression models are expressed.

Tobin's Q/ ROCE = $\alpha + \beta 1 \times FBd + \beta 2 \times FBc + \beta 3 \times FCeo + \beta 4 \times FBm + \beta 5 \times FWd + \beta 6 \times FDr + \beta 7 \times F$ $Log.age + €$

Tobin's Q/ROCE = $\alpha + \beta 1 \times FBd + \beta 2 \times FBc + \beta 3 \times FCeo + \beta 4 \times FBm + \beta 5 \times FWd + \beta 6 \times FDr + \beta 7 \times F$ $Log.age + \beta 8 \times F$ **Bank dummy** $+ €$

Analysis of the Empirical Study: Analysis is done on financial data collected from Capitaline database (source: www.capitaline.com). The following section presents descriptive statistics, correlation matrix and multiple regression analysis on sample banks.

Table – I explains Descriptive Statistics of Sample Banks. According to above Table the mean value of Tobin's Q for public sector banks is 1.15 greater than private sector banks for the financial year 2004-2005. This result clearly indicated that stock markets in India have value the public sector banks better than private sector banks. The age of the bank is a vital factor in determining banks earning potential. It is understood that aged bank considerably does better business due to reputation factor. The age is a crucial matter for the firms in financial sector to capture the market share. With reference to Table I, mean age of the public sector banks is 75.09 years and 46 years for private sector banks in India. It is beyond doubt that why 74 percent of the total commercial banking assets are with public sector banks (Source: RBI). The relationship has been established from the table that aged banks can significantly to better business and also carries better appreciation in market place. Public sector banks have bigger board (mean board size is 11.33) than private sector banks (mean board size is 10.75). Number of board committees is one of the yardsticks for better functioning of the bank.

Table-I: Descriptive Statistics of Sample Banks

Public Sector Banks	**Mean**	**Standard Deviation**	**Minimum**	**Maximum**
Board Directors	11.33	2.45	7.00	16.00
Board Committees	7.23	2.82	3.00	13.00
Board Meetings	11.38	3.29	6.00	16.00
Director Ratio	0.19	0.06	0.09	0.36
Age	75.09	27.48	25.00	140.00
Tobin's Q	2.27	5.27	1.00	25.27
Private Sector Banks	**Mean**	**Standard Deviation**	**Minimum**	**Maximum**
Board Directors	10.75	2.84	5.00	17.00
Board Committees	7.20	2.33	3.00	12.00
Board Meetings	13.40	5.74	6.00	24.00
Director Ratio	0.16	0.10	0.06	0.45
Age	46.00	33.15	2.00	89.00
Tobin's Q	1.12	0.155	1.03	1.63

Source: Compiled From Secondary Data Collected

As per as board committees are concerned, both categories of banks have similar mean value of 7. Policy decisions are not only taken in the annual general meeting, but also in regular board meetings. It is general perception that if bank conducts more number of meetings, it is striving to bring transparency in the business dealings and also greatly get benefited from independent directors' expertise in the business. Public sector banks have not done well to outplay its counterpart in conducting number of board meetings. The director ratio is used to judge the executive director dominance in the board. It is illustrated in the table I that executive director dominance is relatively higher in the public sector banks than private sector banks in India.

Table-II: Correlation Matrix Analysis on Indian Domestic Banks

	1	2	3	4	5	6	7	8	9
1.Board directors	1								
2.Board committees	0.220	1							
3.CEO as a Chairman	-0.760	0.018	1						
4.Board Meetings	-0.239	0.028	-0.057	1					
5. Women director	-0.015	0.325*	0.011	-0.084	1				
6. Director ratio	-0.006	-0.049	-0.099	-0.168	0.050	1			
7. Age	-0.087	0.098	-0.032	0.264	0.047	-0.178	1		
8.Tobin's Q	-0.182	0.166	-0.096	-0.178	-0.139	-0.100	-0.313*	1	
9.ROCE	0.077	0.155	-0.085	0.164	0.293	-0.105	0.317*	-0.135	1

Correlation is significant at the 0.05 level (2-tailed)

Table-II shows Correlation Matrix Analysis on Indian Domestic Banks. The correlation matrix results do not present any multicollearity problem among the independent variables. Though, few of the variables are having statistically significant relationship, but none of the variables carrying correlation coefficient of more than 0.8. The significant of this analysis is to fulfill the condition of multiple regression models, where all independent variables should be independent of each other.

Table III: Multiple Regression Analysis on Indian Domestic Banks

Parameters	*Tobin's Q (Model I)*			*Return on Capital Employed (Model II)*		
	Beta	**t test**	**p value**	**Beta**	**t test**	**p value**
1.Board directors	-0.371	-2.461	0.019*	0.134	0.811	0.423
2.Board committees	0.366	2.369	0.024*	-0.009	-0.055	0.956
3.CEO as a Chairman	-0.172	-1.324	0.195	-0.067	-0.426	0.673
4.Board Meetings	-0.250	-1.642	0.110	0.138	0.821	0.418
5. Women director	-0.257	-1.711	0.096	0.301	1.820	0.078
6. Director ratio	-0.192	-1.324	0.195	-0.055	-0.347	0.731
7. Age	-0.343	-2.321	0.027*	0.267	1.645	0.110
F test	2.562*			1.229		
R^2	35.2			21.6		
Adjusted R^2	21.5			5.0		
Number of banks	41			41		

*Significant at 0.05 levels

The Multiple Regression Analysis on Indian Domestic Banks is given in Table-III. According to above table the multiple regressions models are constructed on diffused ownership pattern, where public and private sector banks are put together to account for corporate governance practices influence on

performance in the Indian domestic banks. Here domestic banks consist of both public and private banks in India, which are listed in the stock market. From the table III, it is understood that the multiple regression model I is statistically significant, where F test is 2.562 is significant at 5 percent level and it explains 35.2 variation in dependent variable. There are three independent variables have statistically significant relationships with dependent variable. The board of directors has significant relationship with bank performance, but it has negative influence. The board committees have positive influence over Tobin's Q and age is also sharing similar relationship with dependent variable. In model II, the F test is not statistically significant and it prevents further interpretation of the results.

Table IV: Multiple Regression Analysis on Indian Public Sector Banks

Parameters	***Tobin's Q (Model I)***			***Return on Capital Employed (Model II)***		
	Beta	**t test**	**p value**	**Beta**	**t test**	**p value**
Bank dummy	0.133	0.790	0.435	-0.446	-2.626	0.013*
1.Board directors	-0.374	-2.461	0.019*	0.146	0.957	0.346
2.Board committees	0.366	2.352	0.025*	-0.068	-0.050	0.960
3.CEO as a Chairman	-0.110	-0.672	0.507	-0.275	-1.671	0.104
4.Board Meetings	-0.223	-1.417	0.166	0.046	0.287	0.0776
5. Women director	-0.266	-1.752	0.089	0.329	2.152	0.039*
6. Director ratio	-0.209	-1.417	0.166	0.001	0.006	0.995
7. Age	-0.341	-2.293	0.029*	0.260	1.738	0.092
F test	2.294*			2.202*		
R^2	36.4			35.5		
Adjusted R^2	20.6			19.4		
Public sector banks/ private sector banks	21/20			21/20		

*Significant at 0.05 levels

Table-IV gives Multiple Regression Analysis on Indian Public Sector Banks. The multiple regression analysis shows that the models, which constructed on Indian public sector banks, are perfectly fit. The F test results for both models are statistically significant and also allow for further interpretations of the results. Few variables are having statistically significant relationship with dependent variables namely Tobin's Q and return on capital employed. The public sector banks corporate governance practices significantly influence performance over private sector banks. Public sector banks board of directors and Board committees has statistically significant relationship with Tobin's Q in the multiple regression model I. It is interesting to note that women director in the board is contributing significantly towards bank performance and it is evident from multiple regression model II. Finally, bank dummy used in this models to public sector banks' corporate governance practices influence on performance have emerged as statistically significant variable at 5 levels.

Findings: This paper examined the influence of bank governance practices on performance. **Hypothesis 1** is constructed under the assumption that aged bank able to build better reputation over the years. Later on, banks tend to do better business due to reputation. This is proved to be correct because public sector banks are relatively aged and also carry better market valuation than private sector banks. The result suggested that corporate governance variables such as board committees and board directors do have impact on the bank performance. Hypothesis relating to Indian domestic banks are accepted because **hypothesis II** is statistically significant. This is really expected result, where board committees and board directors significantly related to bank performance. The result showed that public sector banks are relatively better in implementing the corporate governance practices. It is evident from the analysis that Public sector banks' corporate governance practices are significantly different than private sector banks. The **hypothesis III** is seems to be statistically correct, in which three corporate governance variables namely board committees, board director, and women director of public sector banks significantly related to performance. Surprisingly, private sector banks fairing poorly in employing corporate governance practices with respect to public sector banks.

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