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CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: AN EMPIRICAL STUDY OF SELECTED INDIAN BANKS

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ABSTRACT

Corporate Governance is related with corporate entities and performance. Numerous studies have considered the implications of corporate governance structures on company performance. Even though the existing literature is not agreed in its conclusions, the weight of opinion is that there is a significant relationship between governance structures and firm performance. The aim of this research is to study the effect, if any, of corporate governance structures, particularly board structure and CEO duality, on the performance of selected Indian Banks. Using samples of public and private banks operating in India, this research aims to examine the relationship between CEO duality and the proportion of independent directors on firm performance as measured by return on assets (ROA) and return on equity (ROE), using statistical techniques. The further details of this topic are outlined and examined in this research paper.

KEY WORDS: **Corporate Goveranance, Return On Assets, Duality, Independent Directors**

INTRODUCTION:

Corporate Governance is the application of best management practices, compliance of law in letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for suitable development of all stakeholders. Corporate governance rests with the vision and perception of the leadership and a leader need to adopt a vision for corporate governance. Corporate governance is not merely about enacting legislation, it is about establishing a climate of trust and confidence. Ethical business behavior and fairness cannot be legislated. Strengthening corporate governance is fundamentally a political, social, cultural process in which governance and the private sector have to synergies. Corporate governance extends beyond corporate laws. Its fundamental objective is not merely fulfillment of requirement of law ensuring commitment of the board to transparency in managing the company, modernizing long term shareholder value.

The Asian financial crisis of 1997 resulted in most Asian countries seeking to strengthen their corporate governance, transparency and disclosure levels (Ho and Wong, 2001). An effective system of corporate governance controls is considered critical in aligns the interests of directors with those of shareholders. The board of directors has its key role in corporate governance. Their main responsibility is to support the organizations strategy, develop a directional strategy, appoint, supervise and remunerate senior executives and to ensure accountability of the organization to its shareholders, authorities and other stakeholders. The relative effectiveness of corporate governance has a insightful effect on how well a business performs. The Board structure comprising of executive directors and independent directors (also known as 2-tier board) with diverse skills from different background is renowned for their contribution in the organization. Executive directors have direct responsibilities to manage the company's business and resources, while independent directors are responsible to bring an independent judgment to bear on the issue of strategy, performance and resources including the key appointments and standards of conduct. The field of independent directorship is in no way risk free; it should not be treated lightly. It carries significant exposures, financial liability, possible disqualification and consequential damage to future careers.

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An independent director legally bears the same responsibilities as the Executive Directors, but achieves effectiveness by influencing decisions rather than controlling operations. An independent director is a nonexecutive director on the board of a company who has integrity, expertise and independence to balance the interests of various stake holders. The idea of having them is to bring objectivity to board decisions and to protect general interests of the company, including that of minority shareholders. Independent directors are expected to improve the level of compliance of corporate governance of a company.

MEANING OF CORPORATE GOVERNANCE:

The Institute of Company Secretaries of India (ICSI) defines: "Corporate Governance is the application of best management practices, compliance of law in letter and spirit and adherence to ethical standard for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders."

According to Dr. Geeta Gauri Corporate governance is a system by which companies are run. It relates to the set of incentives, safeguards and the disputes resolution process that are used to control and coordinate the actions of the agents on behalf of the shareholders by the Board of directors. Shareholders are responsible for appointing the Directors and auditors. Creating residual value is the primary concern of shareholders, but the process of value creation and its legally are equally important. Hence corporate governance relates to code of conduct, the management of the companies observes while exercising its power. The Kumar Mangalam Committee acknowledges that the fundamental objective of Corporate Governance is the enhancement of long-term Shareholders' value while at the same time protecting the interest of other stakeholders. The report points out that this definition harmonizes the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interest of the other stakeholders in the company such as suppliers, customers, creditors, the bankers.

Nassim Nicholas Tateb *truly* said that:

"We have now moved from diversified ecology of small banks, with varied lending policies to a more homogeneous framework of firms that all resemble one another"

CORPORATE GOVERNANCE AND BANKS:

"Banking is the crucial factor effecting economic development of an economy. It is the life-blood of a country. It is responsible for the flow of credit and for maintaining the financial balances of the economy. Since the nationalization process in 1969 banks have emerged as a tool of economic development along with social justice. The liberalization policy, which was initiated in 1991 created the environment of competition among banks. The emergency of new private sector banks made the existing banks became more quality conscious in service to the customers. Along with quantitative achievements banks turned their focus on quality. Banking has become complex and it has been recognized that there is a need to attach more importance to qualitative standards such as internal controls and risk management, composition and role of the board and disclosure standards. Corporate Governance has become very important for banks to perform and remain in competition in the era of liberalization and globalization. The entry of new private sector banks, the freedom given to public sector banks to access capital market and series of scams particularly the one is Madhavpura Merchantile Co-operative Bank Ltd. has necessitated banks to pay more attention to the corporate governance. "In India, it was only in 1998, when inadequate / inefficient management was identified as one of the key problems associated with bank performance that the corporate governance cropped up in financial sector agenda. In 2000, the Advisory Group on Banking Supervision (M.S. Verma) suggested that all banks should accept a certain minimum level of corporate governance. It examined the issues of ownership in establishing corporate governance practices. In 2001, an Advisory group on corporate governance (R.H. Patil) was

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formed which quickened the reforms to make the boards of these institutions more professional and truly autonomous".

Corporate Governance, one of the most focused and valued disciplines in management in the modern day, is integrated in the new-Basel accord for the effective implementation of the Pillar (Market Discipline) of the same, which depends on the effectiveness of corporate governance. This discipline is based on an integrated strategic and holistic enterprise risk management system for evaluating the financial strength of the banks and there by achieving competitive equality and financial stability.

"Corporate Governance has become inevitable in the banking sector as the risks in financial markets that affects a bank are several and have a more sensitive and intense relationship with the economy than other corporate. From the Perspective of the financial system, Corporate governance involves, the manner in which the business and affairs of the individual institutions are governed by their board of directors and senior management which affect how banks

- Set corporate objectives
- Run the day to day operations
- Consider the interest of recognized stakeholders.
- Align coporate activity and behavior with the expectation that the bank will operate in a safe manner and
- Protect the interest of the depositors

Some other factors are:

- **The Important Role of the Board of Directors:**
  The board of directors plays an important role in the operation of a company. It oversees top management and is entrusted with the responsibility of monitoring and supervising the company's resources and operation.

- **CEO Duality:**
  There are two types of leadership structure, that is, combined leadership structure and separated structure (Coles et al 2001). A firm may adopt the combined leadership structure in which the CEO is also acting as chairman of the board whilst the separated structure clearly divides the positions of CEO from chairmanship.

- **Independent Directors:**
  The role of independent directors on the board of directors is to effectively monitor and control firm activities in reducing opportunistic managerial behaviors and expropriation of firm resources (Fama and Jensen 1983a, b. Brickley et al. 1994). However, independent directors face difficulties in discharging their duties as they are not directly affiliated with the management (Weisbach 1988).

REVIEW OF LITERATURE:

Reviews of literature of the study are stated below:

- **"Pei Sai Fan in his article "Review of literature &Empirical Research on Corporate Governance"** asserted that Corporate Governance is about putting in place the structure, processes and mechanisms by which business and affairs of the corporate are directed and managed for enhancing long term shareholder value by accountability of managers and enhancing firms performance. It also means processes and mechanisms, which help handling the agency problem and the separation of ownership (by shareholders) and control (by managers) which gives rise to conflict of interests within a firm may be addressed such that the interest of the managers are more aligned with that of shareholders. Recently the corporate scandals, involving high incidence of improper

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activities of managers exploiting the resources of a firm at the ultimate expense of shareholders prompt the intense reexamination and scrutiny of some of the existing Corporate Governance practices and also considerable interest in empirical research on the effectiveness of various corporate governance institutions and mechanisms."

- **Mr. Jaime Caruana, chairman of Basel Committee and Governor of the Bank of Spain,** noted that "Sound Corporate Governance is an important aspect for bank's safety and soundness and the stability of the overall financial framework. This paper has been framed by the Basel Committee to foster more effective risk management and greater transparency on the part of the banking organizations."

- **Monika Mahajan in her paper "Corporate governance in banking and financial institutions"** opined that Corporate Governance is a social institution, including a corporate entity which derives its legitimacy from its ability and desire to fulfill social needs. Applicability of corporate governance in banking industry has been focused in this paper. The Banks consider themselves as trustee of its shareholders and should acknowledge its responsibility towards them for creation and safeguarding shareholders wealth. Banks' philosophy for Corporate Governance should lay emphasis on the basic values of 'fairness', 'transparency' and 'accountability', as quoted by World Bank, for improving performance, enhancing the shareholders' value and protecting the interest of the stakeholders."

- **Dr. Gomathi Viswanathan in her article "Corporate Governance in Indian Banks"** discussed about various concepts like: need for corporate governance in banks and recommendations by various committees like: Birla Committee, Basel Committee. Keeping transparency in operations is must to survive and succeed in increasing competition globally. According to them the customer has finally come to hold the centre stage and all banking products are tailor-made to suit his tastes and preferences."

- **C.S. Cheema and Monika Aggarwal** in their paper titled "Corporate governance in Banks" attempted to analyse the status of Corporate Governance in Indian banking sector.

- **Sunanda Chavan in her article "Corporate Governance in Indian Banks"** opined that Corporate Governance is indispensable part of every banking organization. According to her importance of Corporate Governance for banks can be seen through following points:
  - Banks are growth drivers in developing economies like:India
  - Significant source of finance for industries
  - Channels through which the country's savings are collected and used for investments.
  - Recently liberalized banking system through privatization, disinvestments has resulted in giving greater autonomy and freedom to managers.

- **Kumar, Subramanayam and Dasaraju in their paper "Emergence of Corporate Governance in India"** opined the principles which help to adhere to code of Corporate Governance in developing economies like India. According to them attempt have been made to reorganize the economic system of the country after liberalization. As India is a developing economy and one of the attractive destinations for multinationals, Corporate Governance has been undergoing a process of change with a move towards more market based governance.

- **Haniffa and Hudaib in their paper "Corporate Governance and size of Board"** opined that board size and top five substantial shareholdings have to be significantly associated with both market and accounting performance measures. in addition, they conclude a significant relationship of role duality and managerial shareholdings with

accounting performance. The result is robust with respect to controls for gearing, company size, and industry membership and growth opportunities.

TITLE OF THE STUDY:

After going through existing literature in the library, researchers has selected topic as under:

"CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: AN EMPIRICAL STUDY OF SELECTED INDIAN BANKS"

OBJECTIVES OF THE STUDY:

The main objectives of the study are stated below:

1. To indicate the role of corporate governance and financial performance in Indian banks in an effective way.
2. To study the effect of corporate governance structures, particularly board structure and CEO duality, on the performance of Indian Banks.
3. To examine the relationship between CEO duality and the proportion of independent directors on firm performance as measured by return on assets (ROA) and return on equity (ROE), using statistical techniques.

GAP ANALYSIS:

On the basis of evaluation of literature and objectives, researcher found the gap in this area. After considering a few research have been taken for the study, researcher is found following gap: Though lots of research studies have been undertaken in India and abroad covering various areas in Corporate Governance, very little research studies have been undertaken in respect of Financial Institutions, especially Banks. Though the RBI, Ministry of Finance and related Government bodies have made several notable efforts to improve regulation in this sector, very few banks have established an outstanding track record of innovation growth and value creation. This is reflected in their market valuation. To support the Indian banking industry in the prevailing modern and vibrant economy the researcher has undertaken this study to bring prospects of Corporate Governance in the banking sector.

RESEARCH METHODOLOGY:

Researcher analyzed all the data based on secondary data. In this section, the methods employed in the study in testing the research hypotheses are described. The specifics of data collection, and the methods applied to empirically assess the proposed framework are described. The sample consists of ten banks out of which there are six public sector banks and four private sector banks. We have chosen two different periods for analysis purpose: year 2015-16 and 2016-17 in order to test the effectiveness of the board structure on the financial performance of Indian banks, with special reference to Duality and Proportion of Independent Directors over this selected period. Data was obtained from the Annual Reports of the selected banks available on the websites of the banks.

The variables used in the analysis are as follows:

Dependent Variables:

(i) ROA – return on assets (Profit before interest and Tax / Total Assets) x 100 and

(ii) ROE- return on equity (Profit before Interest and Tax / Total Equity) x 100

Independent Variables:

(i) Duality - This is a binary variable which has a value of one if one individual has the joint title of chairman and CEO or if one individual has the executive position and there is no separate CEO. If the posts are separate, it is zero and

(ii) Proportion of independent directors.

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NED (NON EXECUTIVE DIRECTOR): This measures the number of non-executive directors on the board. We have considered two levels of this variable:

- NED 33 - This measure will include binary number of one if the independent directors represent at least one third of the board. Binary number zero represent if the independent directors is less than one third. We expect firms which have more than one third of the board to perform better.

- NED 50 - This measure will include binary number of one if the independent directors represent 50% of the board. Binary number zero represent if the independent directors is less than 50%. We expect firms which have more 50% of independent directors to perform better than firm which do not.

SPSS and Open Stat Statistical Package were used along with a number of statistical techniques like, Multiple Regression Analysis with Dichotomous variables and Mann Whitney U Test, in measuring the relationship between the dependent variable and independent variables. Non parametric tests were conducted since ROE and ROA were not distributed normally. Mann Whitney U Test was conducted to test the hypotheses. This tests the hypotheses that two independent samples comes from populations having the same distributions. The test is equivalent to the independent group's t test.

HYPOTHESIS:

The following hypotheses are:

- H0: There is no significant difference between CEO duality and bank's performance
- H1: There is significant difference between CEO duality and bank's performance
- H0: Proportion of independent directors to board size has not a significant relationship to bank's performance.
- H1: Proportion of independent directors to board size has a significant relationship to bank's performance.

DATA ANALYSIS:

The following data analyses are:

Table 1: Percentage of Banks with Duality and Board Independence

	2015-16	2016-17
DUALITY	92.67%	92.67%
NED 33	68.67%	100%
NED 50	72%	80.33%

Table 2: Performance of Banks With and Without Duality and Board Independence, 2015-16

2015-16	N	ROA%	Z-Score	ROE%	Z-Score
DUALITY	10	71.60	1.44	95.10	0.30
NO DUALITY	1	23.50		2.95	
NED 33					
≥ 33%	7	74.33	0.20	70.25	0.75
< 33%	3	24.50		29.90	
NED 50					
≥ 50%	8	25.50	0.25	75.60	1.50
< 50%	4	72.75		25.30	

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Table 3: Performance of Banks With and Without Duality and Board Independence, 2016-17

2016-17	N	ROA%	Z-Score	ROE%	Z-Score
DUALITY	10	90.50	0.60	90.45	0.30
NO DUALITY	1	7.50		8.30	
NED 33					
≥ 33%	11	100	8.80	100	8.60
< 33%	0	0		0	
NED 50					
≥ 50%	11	67.59	1.50	50.25	1.85
< 50%	3	32.40		50.69	

RESULT:

- **Duality and Board Structure:** Table 1 provides percentage of banks with duality and Board Independence. Thus, the proportion of banks with duality was same in 2015-16 and in 2016-17. This is shown in Table I above, which indicates that 92.67% of banks in both the years had same person for CEO and chairman of board of directors. In contrast, the table shows that more banks had a higher proportion of independent directors in 2016-17 compared to 2015-16. Table I shows that 100% of banks had the minimum one third number of independent directors on their boards in 2016-17 as compared to only 68.67% of the banks in 2015-16. This may be the result of the implementation of Listing Requirements which required all listed companies to have a minimum of 2 or one third independent directors, whichever was higher. In 2016-17, 80.33% of the banks had more than 50% independent directors on its board which is significantly higher than 72% in 2015-16.

- **Performance Based on Duality and Board Independence:** Table 2 and Table 3 give comparison of the performance of banks with duality and board independence with those without duality and board independence for the years 2015-16 and 2016-17.

Table 2 shows that in 2015-16, 11 banks had duality whereas only one did not. Banks with duality had higher ROA (71.60%) than those without duality (23.50%). In terms of ROE, those banks with duality had a significantly higher ROE (95.10%) than bank without duality (2.95%). The result shows that the separation of CEO and Chairman of BOD does not seem to improve performance in terms of both ROA and ROE.Similarly, Table 3 shows the comparison between the variables and ROA/ROE for year 2016-17.

As in 2015-16, in 2016-17, banks with duality have better ROA (90.50%) than those that do not (7.50%). Again in terms of ROE, the results show that banks with duality have a higher ROE (90.45%) than banks without duality (8.30%). The result shows that the separation of CEO and Chairman of BOD does not seem to improve performance in terms of both ROA and ROE.

However, as for 2015-16 there is no significant correlation between the variables and ROA/ROE except for NED33 in case of year 2016-17. This means that there is a significant correlation between number of independent directors being more than 33% and banks financial performance. But this result may not be reliable for larger sample. Also, all

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the Z -values are between -1.96 and 1.96 which means that there is no significant correlation.

LIMITATIONS OF THE STUDY:

The study focuses on board structures and CEO duality to draw conclusions on corporate governance and financial performance. This is a limitation. The results obtained cannot be generalized to say that there is no relationship between corporate governance and financial performance because of very small sample size, restricted due to the non-availability of data. Many other studies show otherwise. Also, the use of ROA and ROE as proxies for financial performance has its limitations. A more robust indicator would include more than two proxies for financial performance.

FINDING & CONCLUSION OF THE STUDY:

- NED50 and DUALITY have inverse relationship with ROA for both the years, whereas, NED33 has a positive relationship with ROA for year 2015-16. For 2016-17 it has no impact on ROA as well as ROE since there was no bank with NED33 taking value zero in our sample, for this year.
- The negative impact of DUALITY on ROA for both the years signifies the importance of separation of responsibilities principle.
- There is an inconsistency in the relationship of ROE with NED50 and DUALITY in both the years. This may suggest ROA to be a more consistent indicator of financial performance.
- There is significant difference between CEO duality and bank's performance.
- Proportion of independent directors to board size has a significant relationship to bank's performance.

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