Corporate Governance and Financial Performance: A Case of Indian Banking Industry

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Abstract
The issue of Corporate Governance is of much concern for the banking sector as these financial institutions are the machines for economic growth both in developing as well as developed nations. It is extensively commended that good governance will lead to better performance. With this concept the present study attempt to examine the relationship between corporate governance and the performance of Indian banks. The study uses a sample of thirteen banks included in the S & P Bankex for the financial year 2012-2013. Corporate governance scores are calculated by the formulation of a comprehensive Index constituting different parameters of corporate governance based on SEBI regulations, previous literature and the index formulated by earlier researchers. Score obtained from the index are the independent variables. Whereas, Return on Assets is used as a measure of performance and is the dependent variable of the study. Based on the regression results, different committees constituted by the banks are significantly related with their performance.

Keywords: Corporate Governance, Corporate governance parameters, Comprehensive Index

Introduction
Corporate Governance is a mechanism to structure, operate and control a company with the objective to achieve long-term strategic goals of safeguarding the interests of shareholders and different stakeholders. Besides meeting the environmental and local community needs the aim of corporate governance is to govern the firms by complying with the legal and regulatory requirements. It is concerned with the proper implementation of policies and procedures by a company to satisfy its related parties including shareholders, employees, customers, suppliers, regulatory authorities and the community at large. The concept of Corporate Governance is as old as the corporate world but the issue came into limelight after various corporate failures took place. Scandals like Enron, WorldCom, Satyam and many more shook the interests of investors very badly. The reason behind these mishappenings was the poor governance system and so alarmed the authorities to came up with strict and in depth policy frameworks.

Indian authorities took the first initiative in 1996 when the Confederation of Indian Industries developed a code for corporate governance to be adopted by Indian Companies. But still there was need for further strict regulations to be imposed on Indian companies. So SEBI came up the regulations for listing companies in 1999, which included mandatory and non-mandatory recommendations. These guidelines played a prominent role in the Indian corporations. Followed by CII and SEBI other regulatory authorities also actively participated in strengthening the corporate governance system of India. Department of Company Affairs amended Companies Act 1956, J J Irani Committee report on Company Law also attempted to strengthen the governance, and Ministry of Corporate Affairs came up with the voluntary guidelines related to corporate governance. Besides these, to improve the effectiveness and supervision of banking industry Reserve Bank of India has also adopted various corrective actions.

The issue of Corporate Governance is of much concern for the banking sector as these financial institutions are the machines for economic growth both in developing as well as developed nations. Unique character of the institutions and the complexity of the governance problems provides to the issue of corporate governance special emphasis. In addition the banking institutions are the repositories of households’ savings and the consequences of the poor governance of these institutions leads to the involvement of large amount of systematic as well as social cost. Governance of banking institutions is more important than the non-financial firms because of lack of transparency, higher regulations and these also have a critical position in development of economies.

The main focus of the study is on the relationship between governance and performance. It is extensively commended that good governance of banks will lead to more efficient operations and
better performance. Reason behind is the reduction in the incidences of amounts of related party transactions because of proper governance. These lessened transactions results into improved performance. Since the management and board of well governed firm’s functions in a separated and modernized manner so the results are reflected into their organized and efficient operations. Literature on governance and performance also support the thought. Performance of banks is denoted by the profitability and productivity of banking. Bino and Tomar (2007) investigated the relationship between the corporate governance and performance and the results were in line with the acclaimed thought. Jain and Thomson (2008) proved in their case study of the National Bank of Australia that poor governance leads to poor performance. Subsequently corporate governance is supposed to be an imperative component for bank’s better performance, there is little backup to support the prominence that policy makers and market participants has put on the issue of corporate governance. So this research is making addition in the less focused area of corporate governance in banking sector.

Literature Review

An extensive amount of literature was found related to corporate governance and firm performance. Joh (2003), Sanda et al. (2005), Coleman (2007), Spong and Sullivan (2007), Al-Hussain (2009), Ermina and Maria (2010), Adnan et al. (2011), Al Manaseer et al. (2012), Augustine (2012), and Fatimoh (2012). The efforts of the few researchers and the findings of their studies are discussed in this section.

Joh (2003) examined the effect of poor corporate governance on the profitability of firms. Using a sample of 5,829 Korean firms the study considered the period before crisis to find out the relationship between ownership structure, and conflicts of interest and the firm performance. Controlling the other effecting variables the study found that firms with low ownership concentration are less profitable and the firms with disparity between ownership rights and control rights are also showing less profitability. Coleman (2007) used both accounting and market based measures to examine the relationship between the effect of corporate governance and firm performance. Data of 105 firms of Ghana, South Africa, Kenya and Nigeria covering period from 1997-2001 showed that CEO duality is having negative impact while CEO’s tenure, audit committee’s size and frequency of their meetings is having positive impact on corporate performance. Spong and Sullivan (2007) provided an overview of research carried out on how different aspects of corporate governance influence bank performance. The study find that directors posing financial interest in the bank and ownership stake for hired managers are showing positive impact on performance. Also the positions of directors influences their own attitudes towards risk taking and bank’s risk-return trade off. Al-Hussain (2009) explored the relationships between the efficiency of corporate governance structure and performance of nine listed banks of Saudi Stock Exchange. While using ROA as performance measure the results reflected strong relationship between the efficiency of corporate governance and bank performance. Adnan et al. (2011) used the panel data to study the effect of corporate governance on the efficiency of Malaysian listed banks. Different board and ownership variables were used to represent corporate governance and bank efficiency was used to study the performance. The findings showed that small size of board and higher percentage of board ownership are positively affecting the efficiency of banks. Al Manaseer et al. (2012) empirically tried to find out the impact of different dimensions of corporate governance on the performance of Jordanian Banks. Data of 15 banks quoted on ASE reveals that number of outside board members and foreign ownership has positive relationship with performance while separation of CEO’s and Chairman’s role and the size of board shows negative relationship with the performance. Augustine (2012) investigated the relationship between the board characteristics represented by board size, gender, ethnicity, skills, duality and nationality and financial performance depicted by accounting measure i.e. Return on Assets. Panel data collected from the annual reports of 122 Nigerian firms between 1991 and 2008 revealed no significant association between board characteristics and firm performance in particular. Between different variables of board characteristics CEO duality was positively associated with the Nigerian firm’s performance.

Most of the literature relating corporate governance and firm performance is taking ownership structures and boards into consideration as governance dimensions. It was found that banking sector was of lesser concern for researchers. Taking into account these studies, the aim of the paper is to find out the relationship between corporate governance of banks and their performance.

Research Methodology:

The prime concern of the study is the Indian banking sector. So the sample for the study comprised of those thirteen banks including public sector as well as private sector banks which are included in the BSE S & P Bankex. Data culled out from the annual reports for the year 2012-2013 of these banks became the main source of information. Disclosures made in the annual reports and on the websites of the sample banks related to the measures of corporate governance and financial indicators were used to determine the quality of governance and its impact on performance.
Hypothesis:

Based on the review of literature on various studies indicating mixed results, the following hypothesis has been developed for the present study:

Ho: Corporate Governance has insignificant effect on the performance of Indian banks.

Index Formulation:

A comprehensive un-weighted index was formulated to ascertain the level of governance in the selected banks. Both mandatory and non-mandatory dimensions of governance formed the part of index so articulated. The dimensions used in the index were obtained from the Clause 49 of Listing Agreement, SEBI guidelines. The dimensions were also collected from the previous literature and the index formulated by earlier researchers. The total scores of different parameters obtained from the un-weighted index is additive (Cooke, 1992)

Variables

Corporate governance is the independent variable of the study which is to be obtained from the scores calculated for different parameters of governance. Different independent parameters considered in the study are Board composition and procedures, Shareholders’ right, Non mandatory recommendations, Audit, remuneration and Shareholders’ / Investors Grievance Committee. The performance provides a clear picture of a firm’s health and is depicted by the profitability of the firm. Numerous studies have been carried out earlier related to the corporate governance mechanisms and the performance measures. Different measures of performance were used in these studies including accounting or market valuation measures or both measures together. Klapper and Love (2004), Barako and Tower (2007) Bhagat and Bolton (2008), Al-Hussain (2009), Brown and Caylor (2009) used Return on assets. In line with the previous studies, the analysis will employ Return on Asset (ROA) as a dependent variable and proxy for performance. Return on asset to a certain extent provides an insight into the future by involving the approximations on issues like depreciation and goodwill of companies. As managers have direct responsibility for the most efficient utilization of the company’s assets and its operations, the ROA ratio enables the users of financial statements to evaluate the effectiveness of its corporate governance system and management (Epps and Cereola, 2008).

\[ \text{ROA} = \frac{\text{Net Profit after tax}}{\text{Total Assets}} \]

Analysis and Interpretation

Regression model \[ \gamma = \beta_0 + \beta_1 \text{BCP} + \beta_2 \text{SR} + \beta_3 \text{NMR} + \beta_4 \text{ARSC} + \beta \text{Size} + \varepsilon \] has been used to determine the relationship between corporate governance and performance. In this model, BCP depicts Board composition and procedures, SR – Shareholders’ right, NMR – Non mandatory recommendations, ARSC – Audit, Remuneration and Shareholders’ / Investor grievance committee. While, natural log of Total assets as an alternative proxy for size.

Table 1: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.845</td>
<td>.713</td>
<td>.509</td>
<td>.32104</td>
</tr>
</tbody>
</table>

Table 1 reports the value of adjusted R² in the model equals to 0.509. The value implies that 50.9% variation in corporate governance variables, explained by independent variables in the model.

Table 2: ANOV*A

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>1.796</td>
<td>5</td>
<td>.359</td>
<td>3.484</td>
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<tr>
<td>1</td>
<td>Residual</td>
<td>.721</td>
<td>7</td>
<td>.103</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.517</td>
<td>12</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: ROA
b. Predictors: (Constant), Log Size, Shareholders’ Right, Non Mandatory, Board composition and Procedures, Audit, Remuneration, Shareholders’ / Investor Grievance Committee
The regression coefficients of independent variables designate the magnitude and the direction of the relationships with dependent variables. The regression results show that various committees of the banks (Audit committee, Remuneration committee and Shareholders’ / Investor Grievance committee) has a positive and most significant impact on the profitability of the banks measured by return on assets (Table 3). Board composition and procedures are positively but insignificantly related to the dependent variable. Whereas, Shareholders’ right and Non Mandatory recommendations have negative and insignificant association with the return of the banks. Size measured by Ln Total Assets also has a negative and insignificant impact on the profitability of banks. The results are inconsistent with Sanda et al., 2005, Spong and Sullivan, 2007, while substituting the findings of Garg, 2007 on a negative relationship between board attributes such as size and board independence and firm performance. The reason behind variation in the results of earlier studies from the present one might include the involvement of broader range of corporate governance variables considered to measure the level of corporate governance.

**Conclusion:**

The importance of corporate governance in today’s scenario cannot be suppressed. It enhances the performance as well as competitiveness and is a clear path for achieving business excellence. The present study presents the evidence on the relationship between corporate governance score and the performance in Indian banks using a sample of 13 banks of the financial year 2012-2013. The study documents that various committees formulated under the corporate governance mechanisms plays a much important role in enhancing the performance of banking organizations. Klein (2008) also argued in favor to formulate various specialized committees on audit, remuneration and appointment. Formulation of audit committee, remuneration committee and shareholders’ / investor grievance committee with the aim of having proper internal control, risk management, adequate check on the implementation of policies related to remuneration of directors and senior management and also to cater to the complaints of various shareholders and investors. The evidences provided by the study supports that these measures leads to the better performance of Indian banks.

There are certain limitations of the present study that must be acknowledged. The study is based on the sample size of thirteen top banks and excluded the other banks from the sample. This might have resulted to data inconsistency. The study is also restricted to sample period of 2012-2013. The results would be different if the results hold during a larger sample size and different sample period. Finally in this paper only a single dimension of bank performance i.e. accounting measure has been used that has further scope of extension by addition of other measures. However, corporate governance is most likely to impact the performance of banks from different dimensions. In addition to accounting measures, operating measures, market valuation or efficiency of banks all are subject to have positive influence of better corporate governance which can be addressed in further research.

**References**


### Annexure: Percentage of disclosures

<table>
<thead>
<tr>
<th>Banks</th>
<th>Board composition &amp; Procedures</th>
<th>Audit, Remuneration, Shareholders’ / Investor grievance Committee</th>
<th>Shareholders’ Right</th>
<th>Non Mandatory Recommendations</th>
<th>Log Size</th>
<th>ROA</th>
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</thead>
<tbody>
<tr>
<td>Kotak Mahindra</td>
<td>60.71</td>
<td>95</td>
<td>87.5</td>
<td>40.0</td>
<td>12</td>
<td>1.81</td>
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<tr>
<td>Federal Bank</td>
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<td>80</td>
<td>93.75</td>
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<td>12</td>
<td>1.35</td>
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<td>75</td>
<td>40.0</td>
<td>13</td>
<td>0.65</td>
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<tr>
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<td>81.25</td>
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<td>87.5</td>
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<td>81.25</td>
<td>40.0</td>
<td>12</td>
<td>1.63</td>
</tr>
<tr>
<td>Bank of Baroda</td>
<td>53.57</td>
<td>75</td>
<td>75</td>
<td>53.3</td>
<td>13</td>
<td>0.82</td>
</tr>
<tr>
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<td>65</td>
<td>87.5</td>
<td>73.3</td>
<td>12</td>
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</tr>
<tr>
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<td>81.25</td>
<td>46.7</td>
<td>13</td>
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<tr>
<td>PNB</td>
<td>32.14</td>
<td>70</td>
<td>87.5</td>
<td>46.7</td>
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<tr>
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<td>53.57</td>
<td>95</td>
<td>81.25</td>
<td>80.0</td>
<td>13</td>
<td>1.9</td>
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<td>93.75</td>
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<td>0.91</td>
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