CORPORATE GOVERNANCE PRACTICES IN THE BANKING SECTOR OF INDIA: DOES THIS REALLY MATTER?

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Abstract
A well governed institution is expected to use its resources optimally and, thus, perform more efficiently and contribute positively to economic development of a nation. However, often, it can be seen that poor management of the stakeholders leads to less than optimal strategic directions for an institution. Due to global financial crisis and rising issues of the banking sector, corporate governance is one of the factors that have gained considerable attention. Recent drive of the governance issues of the banking sector of India is expected to bring positive change in the financial sector and, hence, it is crucial to assess whether complying with governance codes leads to desired outcome or not. Specifically, the main purpose of this study is to examine the relationship between performances of commercial banks with corporate governance factor along with some internal and macroeconomic variables. Thus, more than 25 listed commercial banks in the Bombay Stock Exchange (BSE) were considered for the study. Listed commercial banks in the BSE have been considered and the study shows a positive relation between corporate governance and performances of banks, the statistical insignificance of the relation raises concern regarding various issues of corporate governance in the financial sector of India.

1 Introduction
Banking system plays a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Indian banking industry, the backbone of the country economy, has always played a key role in prevention the economic catastrophe from reaching terrible volume in the country. The Indian banking system is among the healthier performers in the world. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital efficiency are vital for success & continued survival of banks. In the liberalized economic environment and integration of the country, in to world market the corporate sector in India at present cannot ignore the importance of Corporate Governance. Corporate Governance is now an issue and important factor that can be used as tool to maximize wealth of shareholders of a corporate. Corporate Governance aims are the Vision, Values and Visibility.

The researchers, academicians and policy actors put forth sincere effort to recognize the factors that influence the operations of financial institutions and, hence, contributions of the
financial institutions in the economy of the country. And, among all the mainstream factors, corporate governance is one of the factors that have gained considerable attention recently due to several contemporary issues regarding governance issues of the financial sector of the nation and, hence, it has become imperative to measure the impact of it on banks’ performances. In general, it is important to have a transparent and healthy banking system for the growth and development of the economy. For this reason, this sector needs more supervision. Because of the global financial crisis, experts realized that bank needs better supervision and good governance. Sound corporate governance of banks can also lower the investment risk of investors and helps to reduce the cost of financing, which will ultimately introduce a steady flow of foreign investment into the country. As mentioned earlier, nowadays many researchers are mostly concerned about the relationship between governance and performance. A good governed bank is expected to perform more efficiently.

Best corporate governance practices will enable banks to:

- Increase efficiency of their activities and minimize risks;
- Get an easier access to capital markets and decrease the cost of capital;
- Increase growth rate; Attract strategic investors;
- Improve the standards of lending; Protect the rights of minority shareholder and other counterparts;
- Strengthen their reputation and raise the level of investors and clients’ trust.

There are also having some problem such as basic reasons for the growing interest in corporate governance. Such as, if a bank fails to practice good corporate governance or lack of effective governance within the institution, it may cause insolvency of the bank and that may result in lack of confidence in the financial system of the country, because the confidence of the people in the entire banking system is important for a proper economic development of the country. It is widely argued that effective corporate governance practices are fundamental to gain and maintain the confidence of the people on banking system.

2 Literature

Different authors define corporate governance differently based on their own point of view. A Company Governance Score (CGS) reflects Standard & Poor’s assessment of an individual company’s corporate governance practices and policies. This focuses on the internal governance structure and processes at an individual company. For purposes of the CGS, corporate governance encompasses the interactions between a company’s management, its board of directors, shareholders and other financial stakeholders (McGraw-Hill Companies Inc., 2002).

According to IFC (2014), “at the Banks and Bank Systems, Volume 12, Issue 1, 2017 29 company level, these goals begin with providing companies with a powerful analytical tool. Scorecards are a useful basis for companies to start an analysis of their governance practices. Scorecards help to identify shortcomings against locally defined standards and/or generally accepted international standards of good practice. The findings of a scorecard can, in turn, be used to help the company to develop a corporate governance improvement plan. The ultimate outcome should be better operational performance and lower risk as a result of better governance practices”. Moreover, codes of good corporate governance present a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, as well as the selection, remuneration and dismissal of directors and top managers. The codes serve to improve the overall corporate governance of corporations, especially when legal
environments fail to ensure adequate protection of shareholders’ rights (Abdel Shahid, S., 2001). There are many potential users of scorecards, such as companies, regulators, stock exchanges, institutes of directors, investors, students, researchers and development finance institutions. Each user has different purpose to use it and fulfill their needs.

Haron and Azmi (2004) statistically proved that there is a direct relationship of inflation rate and indirect relationship of real interest rate on ROA.

Athanasoglou et al. (2006) examined South-Eastern European banks’ performance and the result shows high earnings during peak inflation periods and no noticeable effect of GDP.

Davydenko (2011) showed that both GDP and inflation have a positive relationship with ROA of Ukrainian banks.

Aburime (2008) examined on profitability of Nigerian banks and concluded that both real interest rate and inflation have a considerable link with ROA and positively affect bank profitability.

Moreover, Sayilgan and Yildirim (2009) investigated the performance of the banks of Turkey and found that the profitability of the banking sector is increased along with declining inflation rate.

Samuelson (1945) found a positive of banks’ profitability to rising interest rates. Samuelson Paul A. (1945) showed that when interest rate increases, it actually effect to borrowers, but it does not affect banks’ performance. Here, it is explained that borrowers face the impact of higher interest rate but banks profitability is not affected as when interest rate increases, bank charges more from borrower than they pay to the depositors of the banks so that both the depositor and the borrower have to tolerate this impact.

It is worth mentioning Boyd et al.’s (2001) research findings where they presented the summary of the impact of inflation on the performance of the financial/banking sectors.

Objectives:

- To examine role of corporate governance of Indian banking sector.
- To examine the relationship between performances of commercial banks with corporate governance factor along with some internal and macroeconomic variables.
- Also to determine various factors affecting corporate governance in financial service sector.

3 Methodology and Data Analysis

In this study, apart from the corporate governance factor, some other factors that have significant impact on performance of the banks are also explored. Bikker and Bos (2008) stated that performance of banks can be expressed in terms of competition, concentration, efficiency, productivity and profitability. Here, the bank specific variables such as Corporate Governance Score, Size, Risk, Efficiency and external variables such as GDP, Inflation Rate, and Real Interest Rate are considered as predictors. On the other hand, ROA considered as proxy for profitability of the banks.

3.1 Dependent variable:

ROA. Return on assets (ROA) is an indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings (Investopedia, 2003). ROA is calculated by dividing after tax net income
by total asset or average total assets of a company. ROA shows us what earnings were generated from invested capital in a company.

3.2 Independent Variables:

3.2.1 Corporate governance score.
According to IFC (2014), “a scorecard is a quantitative tool to measure the level of observance of a code or a standard of corporate governance. Scorecards compare governance practices to a benchmark. Typically the benchmark is a national code of corporate governance or an international code or standard. Scorecards are not used principally to measure regulatory compliance. Rather, scorecards measure the observance with a voluntary code of best practice. Scorecards are used to assess a company’s governance practices, show progress over time, and compare different companies and even groups of companies within or across countries”. It can measure the quality of governance practices in companies. It can show us whether the companies properly follow the recommended codes. It can be used to compare practices between companies and also between countries. The total score achieved by each of the banks has been used as the measure of bank compliance with the CCG (Islam, Sathye & Hu, 2005). Here in this study, score is the main independent variable of whose influence over dependent variable (ROA) is measured. It is hoped a have a positive relationship between them could be found. According to the information in annual reports of banks, there are 99 elements of corporate governance. If any element is complied by a bank, it would score 4 and if not, then, 0. Thus, the following hypothesis is proposed: H1: There is a significant (positive) relation existing between CCG and ROA.

3.2.2 Size of bank.
In this study total assets of the banks are used as a proxy for bank size like most finance literature. Generally it is expected that the effect of bank size on profitability is positive. Smirlock (1985) find a positive and significant relationship between size and bank profitability. However, banks with higher total asset may do not perform well financially. Moreover, size alone may not affect bank performance positively. Different studies have found a positive, some have found negative and also some have a non-significant relationship between banks performance and size of the bank. Thus, the study hypothesizes that: H2: There is a significant (positive or negative) relation existing between size and ROA.

3.2.3 Risk.
Risk is the position where the actual return of an investment is different than expected return. It means the possibility of losing the original investment and the amount of interests that may earn on it. Banks face different types of risks. Credit risk is one of the most important risks faced by banks. Prior studies founds there is a strong relationship between risk and the performance of banks and it is also usual to notice that too much risk exposure deters profits of banks. Natural logarithm of total provision for bad debt was taken to measure risk. Thus, the study hypothesizes that: H3: There is a significant (negative) relation existing between Risk and ROA.

3.2.4 Efficiency.
The term “efficiency” is one of the key concepts for financial institutions. It has been extensively studied due to its importance. Operating (productive) efficiency denotes whether a firm is cost minimizing (consuming less inputs for the same level of outputs) or profit maximizing (producing more outputs for the same amount of inputs) (Beccalli et al., 2006). Thus, there are two types of technical efficiency based on the orientation: input-oriented and output oriented (Laeven, 1999). Hays, De Lurgio, Gilbert (2009) investigated that “the efficiency ratio is calculated by dividing overhead expenses by the sum of net interest income and non-interest or fee income. It is a measure of how effective a bank is in using overhead

expenses including salaries and benefit costs and occupancy expenses, as well as other operating expenses in generating revenues. Other things being equal, a decrease in the efficiency ratio is viewed as positive, while a rising efficiency ratio is generally undesirable. The efficiency ratio can rise temporarily when a bank expands facilities”. Thus, the study hypothesizes that: H4: There is a significant (negative) relation existing between efficiency and ROA.

3.3 Macroeconomic variables.
Along with channelling funds efficiently, Banks provide a bundle of different services and, thus, considered as the most important financial intermediaries in the economies. Banks play a vital role in many operations in the economies. The efficiency of the performance of these banks can also affect economic growth. On the other hand, many economic factors can affect banks’ profitability. Here, three important determinants are taken to identify their impact on banks performance: GDP, inflation, and real interest rate. These determinants are reflecting economic environment that affects the profitability of banks.

3.3.1 GDP
GDP basically shows the monetary value of all goods and services produced within a country and within a specific period of time. In a country, GDP measures the total economic activates and it may affect the performance of banks. Alpera& Anbar (2011) mentioned that “It is expected to have an impact on numerous factors related to the demand and supply for banks deposits and loans”. According to the literature on the association between economic growth and financial sector profitability, GDP growth is expected to have a positive relation on bank profitability (Bikker and Hu, 2002). Hence, we expect to have a positive relationship between them. So, we propose that: H5: There is a significant (positive) relation existing between GDP and ROA.

3.3.2 Inflation rate.
Inflation is the rate at which the price level of goods and services increases and it decreases the purchasing power of people. Inflation rate has significant effect on bank performance, but the relationship between them can be positive or negative. Perry (1992) stated that “The relationship between the inflation and profitability may have a positive or negative effect on profitability depending on whether it is anticipated or unanticipated”. If inflation rate is anticipated, banks can adjust interest rate so that they can increase the revenue than the expense. On the other hand, if it is not anticipated, banks cannot make correct adjustment of interest rate and the expense will increase than the revenue. Thus, the study hypothesizes that: Banks and Bank Systems, Volume 12, Issue 1, 2017 32 H6: There is a significant (positive or negative) relation existing between inflation rate and ROA.

3.3.3 Real interest rate.
Interest rate plays an important role in our economy. A real interest is adjusted to remove the effect of inflation to show the real cost of borrowing and real interest income to the lender. It is calculated by Fisher equation, which is deducting inflation from nominal interest rate. The interest rate has significant impact on banks performance. Particularly, for developing counties, it is found that the real interest rate has a positive relation to profitability of banks (Borio et. al., 2015). Thus, the study hypothesizes that: H7: There is a significant (positive) relation existing between inflation rate and ROA.

Table 1. Variables and respective formulas

<table>
<thead>
<tr>
<th>Variables</th>
<th>Formulas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Asset</td>
<td>Net Income/ Total Asset</td>
</tr>
</tbody>
</table>
Corporate Govt. Score (CCG) | If the Corporate governance’s element is complied, it scored 4 and if not, then, 0.
---|---
Size | Natural Log of Total Asset
Risk | Natural Log of provision for bad debt.
Efficiency | Operating income/ Operating expense

### 3.4 Research model.
The model and approach used in this study was found in established existing literature:

\[
ROA = f (CCG, Size, Risk, Efficiency)
\]

Three basic core panel OLS regression equation model were, then, proposed:

1. \[
ROA = \beta_0 + \beta_1 \text{Score} + \beta_2 \text{Size} + \beta_3 \text{Risk} + \beta_4 \text{Efficiency} + \beta_5 \text{GDP} + \beta_6 \text{Inflation} + \beta_7 \text{Interest rate}
\]

2. \[
ROA = \beta_0 + \beta_1 \text{Score} + \beta_2 \text{Size} + \beta_3 \text{Risk} + \beta_4 \text{Inflation} + \beta_5 \text{Interest rate}
\]

3. \[
ROA = \beta_0 + \beta_1 \text{Score} + \beta_2 \text{Risk} + \beta_3 \text{Efficiency} + \beta_4 \text{Inflation} + \beta_5 \text{Interest rate}
\]

### 3.5 Research design.
The study’s main purpose was to identify impact of corporate governance on the performance of private commercial banks of India. This is a cross sectional study, because this research is done based on 4 years of annual reports private commercial banks of India without comparing results over longer time horizon.

### 3.6 Data collection & sampling.
This research has been prepared based on secondary data collected from annual reports of private commercial banks of India. Sampling techniques is simple random sampling techniques.

### 3.6 Data analysis.
Multiple regression analysis has been done to test the relationship between banks’ performance measured by ROA and corporate governance score, size, risk, efficiency and
some macro-economic variables. This analysis is done by using E-Views 8 software to run regression equation calculation, correlations and descriptive statistics.

Table 2. Descriptive statistics of the variables

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Median</th>
<th>Maximum</th>
<th>Minimum</th>
<th>Std. Dev.</th>
<th>No. of observation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.011267</td>
<td>0.010161</td>
<td>0.217471</td>
<td>-0.099702</td>
<td>0.0267361</td>
<td>116</td>
</tr>
<tr>
<td>Score</td>
<td>281.1379</td>
<td>334</td>
<td>396</td>
<td>0</td>
<td>106.6357</td>
<td>116</td>
</tr>
<tr>
<td>Size</td>
<td>25.62433</td>
<td>25.67258</td>
<td>27.20396</td>
<td>22.90881</td>
<td>0.627941</td>
<td>116</td>
</tr>
<tr>
<td>Efficiency</td>
<td>0.476556</td>
<td>0.43545</td>
<td>1.801975</td>
<td>0.054528</td>
<td>0.209013</td>
<td>116</td>
</tr>
<tr>
<td>GDP</td>
<td>30.04427</td>
<td>30.05119</td>
<td>30.22901</td>
<td>29.84568</td>
<td>0.143638</td>
<td>116</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.0787</td>
<td>0.07275</td>
<td>0.107</td>
<td>0.0623</td>
<td>0.017064</td>
<td>116</td>
</tr>
<tr>
<td>Interest rate</td>
<td>0.0545</td>
<td>0.052</td>
<td>0.069</td>
<td>0.045</td>
<td>0.008997</td>
<td>116</td>
</tr>
</tbody>
</table>

3.7 Descriptive statistics of the variables.
Table 1 represents the descriptive statistics of the research. In this study, the sample size is more than 25, so total observation number is 116. Here, descriptive statistics show that the commercial banks of India are fairly compliant with the requirements having an average of 281.14 Corporate Governance Score; though standard deviation is very high, 106.63. 3.9.

3.8 Regression analysis.
In Table 2, the following data got from the output, as ROA is regressed against CCG, size, risk, efficiency, GDP, inflation, and interest rate in three different model.

Table 3. Regression analysis

<table>
<thead>
<tr>
<th></th>
<th>Intercept</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score (CCG)</td>
<td>-1.89490</td>
<td>-0.17646</td>
<td>0.07201</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.7572)</td>
<td>(0.5906)</td>
<td>(0.548)</td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>-0.00465</td>
<td>0.009165</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.3931)</td>
<td>(0.0548)*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------</td>
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<td>--------</td>
<td></td>
</tr>
<tr>
<td><strong>Risk</strong></td>
<td>-0.00240</td>
<td>-0.00363</td>
<td>-0.0033</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.4312)</td>
<td>(0.2634)</td>
<td>(0.217)</td>
<td></td>
</tr>
<tr>
<td><strong>Efficiency</strong></td>
<td>-0.06245</td>
<td>-</td>
<td>-0.05365</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.0000)*</td>
<td>-</td>
<td>(0.0000)*</td>
<td></td>
</tr>
<tr>
<td><strong>GDP</strong></td>
<td>0.069646</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.3043)</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>Inflation rate</strong></td>
<td>0.485319</td>
<td>0.304814</td>
<td>0.21801</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.1637)</td>
<td>(0.1784)</td>
<td>(0.2996)</td>
<td></td>
</tr>
<tr>
<td><strong>Interest rate</strong></td>
<td>-0.52571</td>
<td>-0.01167</td>
<td>0.20198</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.5104)</td>
<td>(0.9675)</td>
<td>(0.4504)</td>
<td></td>
</tr>
<tr>
<td><strong>R2</strong></td>
<td>0.201083</td>
<td>0.055689</td>
<td>0.18802</td>
<td></td>
</tr>
<tr>
<td><strong>Adjusted R2</strong></td>
<td>0.149301</td>
<td>0.012766</td>
<td>0.15111</td>
<td></td>
</tr>
<tr>
<td><strong>F-statistic</strong></td>
<td>3.883288</td>
<td>1.297414</td>
<td>5.09427</td>
<td></td>
</tr>
<tr>
<td><strong>P-value</strong></td>
<td>0.000826*</td>
<td>0.270267</td>
<td>0.00031*</td>
<td></td>
</tr>
</tbody>
</table>

Table 3 shows the GLS results for the ratio operating expenses to total assets (i.e. OPEXP_TA) which is the second proxy for efficiency. Overall, the GLS results of the second proxy of efficiency (i.e. OPEXP_TA) are much weaker as the Chi² value is much lower (i.e. 29.58) than the GLS results of NPL_TL (Chi² of 71.17). Consistent with the results in Table 2, board size is still found to be significant (at p<0.10). Institutional ownership (i.e. IOWN) is also found to be significant; however, the sign of relationship contradicts theoretical expectation. As for the control variables, only firm size is found to be significant.

### 4 Findings
The findings of this study have important implication for the corporate governance variables, smaller board size and higher ratio of block ownership consistently seem to have better
efficiency. However, the rest of the corporate governance variables do not seem to have significant and consistent impact on efficiency. There are few factors which could explain weak system of corporate governance.

5 Conclusion
We are conclude that the private commercial banks play an important role in our economy. Sound corporate governance should ensure better banks performance. Based on some prior studies and also in this study, it is found that corporate governance has a positive relationship with banks performance though the relationship is not significant. Only few years ago corporate governance practice is embraced by all the private commercial banks in India. But after introduction of the CCG, the practices of corporate governance have been significantly improved. The aim of this study was to investigate whether compliance to corporate governance codes do really matter for the commercial banks of the country. Hence, three models used to identify the influence. All the models show that the corporate governance has positive relation to the performance of commercial banks in India, however, none of them are statistically significant.

Actually, a well managed bank must perform better than that of others; otherwise compliance to corporate governance codes would lose its essence. Thus, on the one hand, the result indicates probable inherent management issues of the banks and/or the market. Else, it can be argued that may not be in the short run, reflection of corporate governance’s impact on performance may get its strong foothold in the days to come. Nonetheless, findings of the study will be helpful for future researches, policy makers and bank managements. Least, as corporate governance has a positive relationship with banks performance, it can be inferred from the findings that sound corporate governance is needed for a stable, well-functioned and well performed banking system in India.

References


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