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Corporate Governance Structures and Financial Performance of Selected Indian Banks

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Abstract

Numerous studies have considered the implications of corporate governance structures on company performance. Although the existing literature is not unanimous 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. Results show that there is no significant relationship between corporate governance structures and financial performance of the banks.

Keywords: Return on Assets, Return on Equity, Duality, Independent Directors

Introduction

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 crucial in aligning the interests of directors with those of shareholders. The board of directors has its key role in corporate governance. Their main responsibility is to endorse the organization's strategy, develop a directional policy, 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 profound effect on how well a business performs. The Board structure comprising of executive directors and

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independent directors (also known as 2-tier board) with mixed skills from varied background is recognized 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.

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 non-executive 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.

The aim of this research paper is to study the effect, if any, of corporate governance structures, particularly board structure and CEO duality, on the performance of 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.

Meaning of Corporate Governance

Before delving further on the subject, it is important to define the concept of corporate governance. The vast amount of literature available on the subject ensures that there exist innumerable definitions of corporate governance. To get a fair view on the subject it would be prudent to give a *narrow* as well as a *broad* definition of corporate governance. In a *narrow* sense, corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders. While corporate governance essentially lays down the framework for creating long-term trust between companies and the external providers of capital, it would be wrong to think that the importance of corporate governance lies solely in better access of finance. Companies around the world are realizing that better corporate governance adds considerable value to their operational performance:

- It improves strategic thinking at the top by inducting independent directors who bring
  a wealth of experience, and a host of new ideas.
- It rationalizes the management and monitoring of risk that a firm faces globally.
- It limits the liability of top management and directors, by carefully articulating the decision making process.
- It assures the integrity of financial reports.
- It has long term reputational effects among key stakeholders, both internally and externally.

In a *broader* sense, however, good corporate governance- the extents to which companies are run in an open and honest manner- is important for overall market confidence, the efficiency of capital allocation, the growth and development of country’s industrial bases and ultimately the nation’s overall wealth and welfare. It is important to note that in both the narrow as well as in the broad definitions, the concepts of disclosure and transparency occupy centre-stage. In the first instance, they create trust at the firm level among the suppliers of finance. In the second instance, they create overall confidence at the aggregate economy level. In both cases, they result in efficient allocation of capital. It is therefore appropriate that corporate governance regulations in India seek to promote the rights of shareholders, while at the same time ensuring that the interests of other stakeholders are not adversely impacted.

Corporate Governance in Indian Banks

The initial formal moves towards corporate governance in India can be traced in 1997 with the voluntary code framed by the Confederation of Indian Industry (CII). A number of companies over the next three years (nearly 30 large listed companies accounting for over 25 per cent of India's market capitalization) voluntarily adopted the CII code. 2. The next major cornerstone in the Indian case has been the SEBI Committee chaired by Shri Kumar Mangalam Birla (1999), as the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies and the state of capital markets. The Committee recommended that the fundamental objective of corporate governance is the "enhancement of shareholder value**,** keeping in view the interests of other stakeholder". The Committee made recommendations of far-reaching implications for several issues, such as, the independence of board, accounting standards and financial reporting, share-holders' rights and responsibilities, and formation of audit and remuneration committee.

The initial move towards corporate governance in banks can be traced in the Advisory Group on Corporate Governance for the RBI Standing Committee on International Financial Standards and Codes, chaired by Dr. R.H. Patil, which submitted its Report in 2001, of corporate governance in India is much closer to the East Asian 'insider' model where the promoters dominate governance in every possible way. Among the various recommendations, strengthening of the Companies Act and the role of Independent Directors deserve special mention. The Group looked into public sectors banks and noted that the first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. Furthermore, as a part of strengthening the functioning of their boards, banks should appoint a risk management committee of the board in addition to the three other board committees *viz*., audit, remuneration and appointment committees. The Advisory Group on Banking Supervision for the Standing Committee on International Financial Standards and Codes, while looking into several areas in which internationally accepted best practices are already in place, probed into corporate governance as well.

The noteworthy minimum benchmarks noted by the Group relate to the following:

- strategies and techniques basic to sound corporate governance;
- organizational structure to ensure oversight by board of directors and individuals not involved in day-to-day running of business;
- ensuring that the direct line of supervision of different business areas are different;
- ensuring independent risk management and audit functions;
- ensuring an environment supportive of sound corporate governance; and
- role of supervisors.

Interestingly, with reference to public sector banks, the Group noted that the nature of a bank's ownership is not a critical factor in establishing sound corporate governance practices and concluded that, "the quality of corporate governance should be the same in all types of banking organizations irrespective of the nature of their ownership". The Group, however, felt that there are some areas where practices in the Indian banking sector fell short of international best practices, *viz.*, a) constitutions of boards, b) their accountability, and c) their involvement in risk management. The Group gave special emphasis on enhanced transparency in the constitution and structure of the board and senior management and in public disclosures. Taking this move towards corporate governance further, the Reserve Bank constituted a Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A.S. Ganguly) to review the supervisory role of Boards of banks and FIs. The Ganguly Consultative Group looked into the functioning of the Boards *vis-à-vis* compliance, transparency, disclosures, audit committees and suggested measures for making the role of the Board of Directors more effective. The Group submitted its recommendations in April 2002. The major recommendations of the Group are the following:

- Government while nominating directors on the Boards of PSBs should be guided by certain broad "fit and proper" norms for the Directors, based on the lines of those suggested by Bank for International Settlement (BIS).
- The appointment / nomination of independent non-executive directors to the Board of banks (both public sector and private

sector) should be from a pool of professional and talented people to be prepared and maintained by RBI.
- It would be desirable to take an undertaking from every director to the effect that they have gone through the guidelines defining the role and responsibilities of directors, and understood what is expected of them.
- In order to ensure strategic focus it would be desirable to separate the office of Chairman and Managing Director in respect of large-sized PSBs.
- The information furnished to the Board should be wholesome, complete and adequate to take meaningful decisions. The Board's focus should be devoted more on strategy issues, risk profile, internal control systems, overall performance, *etc.*
- It would be desirable if the exposures of a bank to stockbrokers and market-makers as a group, as also exposures to other sensitive sectors, *viz.*, real estate *etc.* are reported to the Board regularly.
- The disclosures of progress made towards establishing progressive risk management system, the risk management policy, strategy, exposures to related entities, the asset classification of such lending / investments *etc.* should be in conformity with corporate governance standards, *etc.*
- Finally, the banks could be asked to come up with a strategy and plan for implementation of the governance standards recommended and submit progress of implementation.

The Ganguly Committee recommendations have been benchmarked with international best practices as enunciated in the Basel Paper as well as of other Committees and advisory bodies to the extent applicable to the Indian environment. RBI has also implemented most of the recommendations. In general these regulations have created an enabling framework for improving corporate governance in financial institutions. Subsequently, the circular issued on June 25, 2004 on 'fit and proper' criteria for directors of banks enumerated a number of principles; the following among them deserve special mention, *viz.*,

- undertaking a process of due diligence on the part of the banks in private sector to determine the suitability of the person for appointment / continuing to hold appointment as a director on the

Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria;

- the process of due diligence should be undertaken by the banks in private sector at the time of appointment / renewal of appointment;
- the boards of the banks in private sector should constitute Nomination Committees to scrutinize the declarations;
- Banks should obtain annually, as on March 31, a simple declaration that the information already provided has not undergone change and where there is any change, requisite details are furnished by the directors forthwith.

These principles would go a long way to ensure corporate governance in banks in India.

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. (The board's primary responsibilities have been discussed earlier in this paper). Therefore, the board is collectively seen as a team of individuals with fiduciary responsibilities of leading and directing a firm, with the primary objective of protecting the firm's shareholders' interests (Shamsul Nahar Abdullah 2004). There are three critical board roles that have been identified and studied by a variety of theoretical perspectives inclusive of service roles, control roles and strategic roles (Zahra and Parce 1989, Gopinath et al. 1994, Maassen 1999). This has been further elaborated in a different study that the board should alternatively fill an auditing, a supervisory, a coaching, and a steering role (Strabel 2004). However, the separation between ownership and control mechanism in today's modern organization has resulted in a potential conflict of interest situation (Berle and Means 1932). This is also a consequences of the agency theory in which the self interest of the management is likely to lead them to involve in value-decreasing activities (Jensen and Meckling, 1976). The predicted reduction in value of the firm as a result of the management opportunistic behavior is known as "agency cost" (Jensen and Meckling 1976).

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.

Many studies have been done to identify the implications of CEO duality. There is a claim that the operating performance may be improved as a result of less conflict between the CEO and chairman and/or other directors (Anderson and Anthony 1996). Those firms which have been identified as earnings manipulators are more likely to have a CEO who also serves as a board chair (Deochow et al.1996). The CEO duality in fact has a positive effect on firm performance under certain industries (eg. resource scarcity or high complexity) (Donaldson and Davis 1991). However, one study shows that the lack of separation from the CEO has lead to corporate board being aligned with management rather than shareholders notwithstanding the presence of independent directors (Greenspan 2002-2003). Not only that, those firms which practice CEO duality are likely to have lower shareholder returns (Rechner and Dalton 1991).

The relationship between CEO duality and firm performance is considered neutral/insignificant in certain studies whereby there is no link between CEO duality and firm performance (Berg and Smith 1978). No significant relationship was shown in a different study done using Malaysian public listed companies as sample (Allen Chang 2004). Although the literature is not unanimous in its conclusions, the weight of opinion is that there is a significant relationship between CEO duality towards firm performance.

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). There is evidence to show that independent directors are valued for their ability to advise, to solidify business and personal relationships, and to send a signal that the company is doing well rather than for their ability to monitor (Mace 1986, Herman 1981). Nevertheless, a study of Singapore's directors has indicated that most of the respondents were of the opinion that the optimum level of independent directorship is between 25% and 50% of the total size of the board and the independent directors were more convinced that strong corporate governance enhanced the board effectiveness more than executive directors (Goodwin and Seow 2000). As such, the proportion of independent directors is identified as the other independent variable in this study.

Theoretical Framework and Hypotheses

The framework represents a model which concerns ascertaining the relative importance of the known antecedents of firm's performance. Many researchers found that CEO duality and the proportion of independent directors to board size gives indirect impact towards the firm's performance. For the purpose of this study firms' performance is measured through valuation of Return of Equity (ROE) and Return of Assets (ROA), where profit before interest and tax will be used as denominator because it shows the real performance of a firm as the dependent variable. CEO duality is set as the binary variable and board independence, the number of independent directors to board size, is the independent variables in measuring the relations to firm's performance which is the dependent variable. Past researchers applied different methods in measuring firm performance such as stock price, dividend payable, return on assets, return on equity, gearing ratio and so on. In this study, return on assets and return on equity are used as indicators for firm performance.

CEO duality occurs if the roles of chairman and CEO are combined. The chairman of the board is responsible for managing the board, which may include tasks such as selecting new board members, monitoring the performance of the executive directors and settling any conflicts which arises within the board. The CEO is responsible for the day to day management of the company, including the implementation of board decisions. The companies that practices CEO duality, may have an individual who possesses too much power and might make decisions that do not maximize shareholders wealth. Interest in duality has emerged primarily because it is assumed to have significant implications for organizational performance and corporate governance. The lack of separation has led to corporate board being aligned with management rather than shareholders notwithstanding the presence of independent directors (Greenspan, 2003).

Drawing from the literature on the relationship between a firm's performance and CEO duality, the following hypothesis is made:

H1: CEO duality has a significant relationship to bank's performance

The Cadbury Committee recommended that there should be at least three non-executive directors on the board of quoted companies. Board independence is associated with the entry of outsiders into the board and Cadbury Committee outlined the reasons for having an outside presence on the board as:

- Outside directors broaden the strategic view of boards and they widen a Company's vision
- Outside board members ensure that boards always have their sights on the interests of the companies. They are well placed to resolve conflicts.
- The outside directors bring awareness of the external world and ever changing nature of public expectations to board discussions.
- Outside directors have a clear role in appointing and monitoring the executive team.

The literature suggests that increases in the proportion of outside directors on the board increases firm performance as they can more effectively monitor managers (Adams and Mehran, 2003). Drawing from this tread in the literature on the relationship between independent directors and bank's performance, the following hypothesis is made:

H2: Proportion of independent directors to board size has a significant relationship to bank's performance

Methodology

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 twelve banks out of which there are eight public sector banks and four private sector banks. We have chosen two different periods for analysis purpose: year 2005-06 and 2008-09 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

NED: 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 OpenStat 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.

Results

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 2005-06 and in 2008-09. This is shown in Table I above, which indicates that 91.67% 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 2008-09 compared to 2005-06. Table I shows that 100% of banks had the minimum one third number of independent directors on their boards in 2008-09 as compared to only 66.67% of the banks in 2005-06. This may be the result of the implementation of Listing Requirements in 2005 which required all listed companies to have a minimum of 2 or one third independent directors, whichever was higher. In 2008-09, 83.33% of the banks had more than 50% independent directors on its board which is significantly higher than 75% in 2005-06.

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 2005-06 and 2008-09.

Table 2 shows that in 2005-06, 11 banks had duality whereas only one did not. Banks with duality had higher ROA (74.59%) than those without duality (25.41%). In terms of ROE, those banks with duality had a significantly higher ROE (97.2%) than bank without duality (2.79%). 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.

The results for board independence and performance are inconsistent for the year 2005-06. Table II shows that NED50 companies that had more than 50% independent directors on the board (NED50), had lower ROA (26.78%) and higher ROE (77.66%) than those banks that had fewer independent directors (< 50%). However, for NED33 banks those that had more than 33% independent directors performed better with ROA of 74.33% and ROE of 71.12% respectively, than those who had less than

33% independent directors with ROA of 25.66% and 28.87% respectively. Thus, the results seem to support the recommendation that requires organizations to have at least one third independent members on the board.

In terms of the Z value scores, there is no significance among the variables and ROA/ROE value for the 2005-06 data. In order for there to be a significant correlation, Z -values must be below -1.96 or more than 1.96. So, based on the 2005-06 data, duality and number of independent directors do not have a significant impact on the financial performance.

Similarly, Table 3 shows the comparison between the variables and ROA/ROE for year 2008-09.

As in 2005-06, in 2008-09, banks with duality have better ROA (91.49%) than those that do not (8.51%). Again in terms of ROE, the results show that banks with duality have a higher ROE (90.69%) than banks without duality (9.31%). 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.

The results for independence for year 2008-09 also show the consistent impact of independent directors on both ROA and ROE. . For NED 50 banks, the ROA and ROE were higher than those with less than 50% independent directors. For NED33, we had no bank in our sample having number of independent directors less than 33%. Hence NED33 could not be used to discriminate its impact on ROA and ROE.

However, as for 2005-06 there is no significant correlation between the variables and ROA/ROE except for NED33 in case of year 2008-09. This means that there is a significant correlation between number of independent directors being more than 33% and bank's financial performance. But this result may not be reliable for larger sample. Our sample does not contain any bank with number of independent directors less than 33%. Also, all the Z -values are between -1.96 and 1.96 which means that there is no significant correlation.

Simultaneous Impact

In order to understand the simultaneous impact of the selected explanatory variables on the dependent variables ROA and ROE respectively, we carried out Multiple Regression Analysis with Dichotomous Variables**.** The models applied were:

$ROA= a_0 + a_1 \times NED33 + a_2 \times NED50 + a_3 \times DUALITY + \varepsilon$ and
$ROE= b_0 + b_1 \times NED33 + b_2 \times NED50 + b_3 \times DUALITY + \varepsilon$

Following are the estimated regression models for the years 2005-06 and 2008-09 respectively:

2005-06

ROA=1584.51+4.338 NED33-772.67 NED50-809.07 DUALITY (R-squared=0.3099)
ROE=35.6407+77.74NED33+168.709NED50+430.13 DUALITY (R-squared=0.0231)

2008-09

ROA=5.01167-2.66167 NED50-0.53667 DUALITY (R-squared=0.2026)
ROE=2528.035-1733 NED50-405.68 DUALITY
(R-squared=0.3437)

Conclusions

The above results indicate the following points:

- NED50 and DUALITY have inverse relationship with ROA for both the years, whereas, NED33 has a positive relationship with ROA for year 2005-06. For 2008-09 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 inverse relationship with NED50 justifies that a rational proportion of independent directors in the board should be in the range of 30% to 50% and must not exceed this limit in order to have an increasing ROA. 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.
- For all the above estimated models the value of R-squared is very less indicating a weak relationship between the dependent and independent variables and hence very less predictive power of these estimated models.

The impact of CEO Duality and proportion of independent directors on company performance has received close attention by researchers in corporate governance in recent years. This study hopes to contribute to this line of research. Based on the results of this study, it was found that there is no significant relationship between duality and board independence to bank performance. These results can be evaluated using larger samples.

Limitations and Future Research

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.

This study focuses on the internal processes of a company. But external factors have a significant impact on company performance. Inflation, foreign exchange, macro economy, and interest rate policy may have a more significant impact on company performance than on how a company is regulated internally. This study could be extended to include analysis on other corporate governance issues such as board size, board compensation, ownership structure which impact upon performance. The study could also be augmented with a study of the qualitative aspects of the board that contribute to firm performance, such as the board decision-making process.

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Table 1: Percentage of Banks with Duality and Board Independence

	2005-06	2008-09
DUALITY	91.67%	91.67%
NED 33	66.67%	100%
NED 50	75%	83.33%

Table 2: Performance of Banks With and Without Duality and Board Independence, 2005-06

2005-06	N	ROA%	Z-Score	ROE%	Z-Score
DUALITY	11	74.59054	1.4484	97.20049	0.2897
NO DUALITY	1	25.40946		2.799514	
NED 33					
≥ 33%	8	74.33044	0.1698	71.12397	0.5095
< 33%	4	25.66956		28.87603	
NED 50					
≥ 50%	9	26.78191	0.1849	77.66211	1.4792
< 50%	3	73.21809		22.33789	

Table 3: Performance of Banks With and Without Duality and Board Independence, 2008-09

2008-09	N	ROA%	Z-Score	ROE%	Z-Score
DUALITY	11	91.49167	0.5794	90.69498	0.8690
NO DUALITY	1	8.508327		9.305018	
NED 33					
≥ 33%	12	100	8.6603	100	8.5219
< 33%	0	0		0	
NED 50					
≥ 50%	10	67.59594	1.0742	50.30248	1.2890
< 50%	2	32.40406		49.69752	