IMPACT OF CORPORATE GOVERNANCE ON BANK'S PERFORMANCE

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ABSTRACT

Banking sector is critical to the country's economy and its fiscal policy. The method by which banks are regulated, the approach by which banks are directed and controlled, and, most significantly, carrying out banking activities in accordance of corporate governance norms are critical to the bank's performance. Corporate governance helps us realize and review where a bank is lacking and how it can efficiently increase its performance. The performances of public and private banks differ because of the policies followed and adopted by them.

Introduction

Corporate governance is a set of rules or regulations that shape the control or regulation of the how the enterprises run, control, or regulate themselves. It helps in providing a rationale why organizations needs to be managed and controlled. India's banking system is one of the world's largest and highly complex among other countries. Banks deals with money of the public and their savings, so there is a fiduciary relationship among them which calls for more stringent regulations in banking sectors as compared to other sectors.[1] Due to this distinctiveness of the banking institutions, corporate governance becomes crucial to be followed by the banks. Many public sector and private sector banks are now listed on stock exchange. SEBI has mandated corporate governance guidelines to be followed in listed companies and RBI issued 'Fit and Proper' criteria which provides the selection criteria of directors and tells how the board should be constituted and in the year 2020 RBI has published a paper based on 'basel committee on banking supervision', which encourages creation of an independent board, constitution of various committees and overall aims at improving corporate governance in banking sector in the light of recent frauds[2]. The method by which banks are regulated, the approach by which banks are directed and controlled, and, most significantly, carrying out banking activities in accordance with the demands of stakeholders are critical to the banking sector's performance. The 2 main factor of asset quality is of a bank is GNPA and NNPA ratios, as low non-performance ratio indicates good asset quality[3] and good governance is essential for improving bank asset quality and establishing a favorable link between the two.[4]

Objectives

The purpose of this research is to look at the link between corporate governance procedures and non-performing assets in a number of Indian public and private banks. The study will help us in getting a perspective about the influence of corporate governance policies on Non-

[1] Darmadi, S. 'Corporate governance disclosure in the annual report: An exploratory study on Indonesian Islamic banks' (2013) 29(1), 4-23 Humanomics <https://doi.org/10.1108/08288661311299295> accessed 28 October 2021
Wahyudi, S., Sari, S. P., Hersugondo, H., & Udin, U. 'Capital Adequacy Ratio, Profit-Sharing and Return On Asset: Case Study of Indonesian Sharia Banks' (2019) 16, pp.138-144 Wseas Transactions on Business and Economics
[2]RBI Publication
https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/DISCUSSION08CA382F39604B10B420A8A43B0DB0C1.PDF
[3] http://www.pbr.co.in/2017/2017_month/Oct/8.pdf as per RBI guidelines as on Balance Sheet date
[4] HifzaInam & Mukhtar 'Corporate governance and its impact on banking sector in Pakistan' (2014) Vol.6, No.3 pp.106-117, International Journal of Information, Business and Management

Performing Assets in public and private Indian banks. For understanding the corporate governance concept in Indian public and private banks these banks were considered, HDFC, ICICI, Axis Bank, Bank of Baroda, State Bank of India and Punjab National Bank. Furthermore, studies conducted by other scholars are also taken into the picture. The study aims to provide answer for the following research questions:-

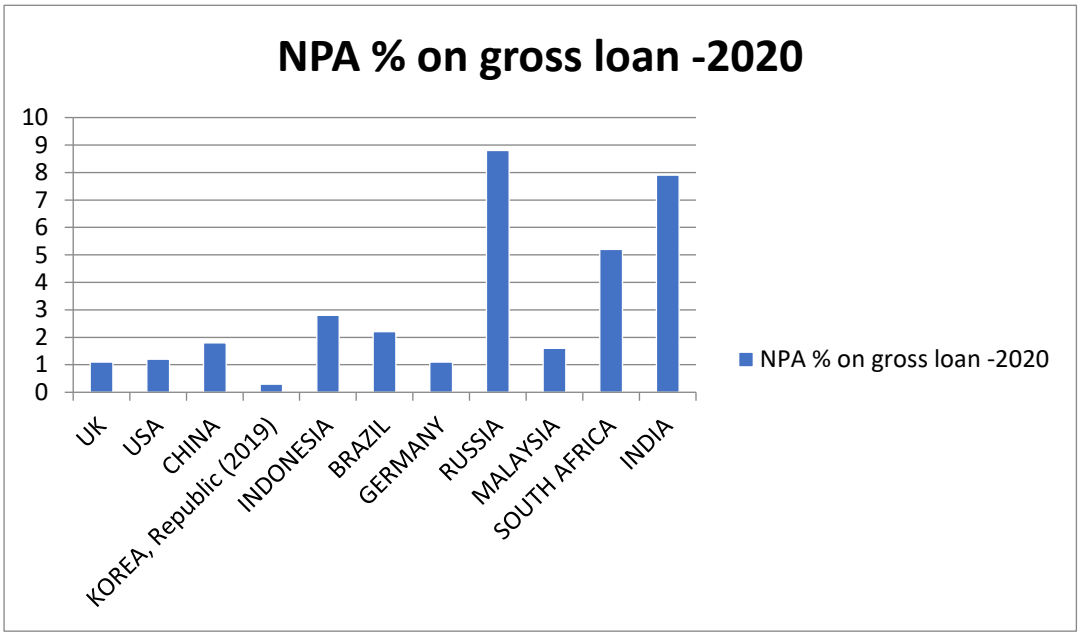
- To determine the impact of corporate governance on bank performance w.r.t Private and Public sector banks of India.
- Whether the corporate governance tools enhance the bank performance?

Corporate Governance and Bank Performance

When we want to examine a bank performance the first aspect we need to analyze is its non-performing assets as they reduced banks capital and affects their financial health. The NPA's of banks must be regulated and minimized in order to boost banks financial performance. The World Bank data (Figure 1), shows that Banks NPA loans to gross loan of India is comparatively higher to most developing countries, the only exception is Russia. These huge unsettled NPAs have a negative impact on the policy making decisions and the economy of our country. Companies which are listed in US,UK, Italy document better corporate governance which leads to increased market valuation and return on asset.[5] Furthermore, corporate governance strategies adopted by Korean companies resulted in increase of foreign ownership and better equity performance.

[5] Bubbico, R., Giorgino, M. Monda, B. 'The impact of Corporate Governance on the market value of financial institutions: empirical evidences from Italy' (2012) Vol. 7 No. 2, pp.11-18 Banks and Bank Systems <https://www.researchgate.net/publication/256029050_The_Impact_of_Corporate_Governance_on_the_Market_Value_of_Financial_Institutions_Empirical_Evidences_from_Italy> accessed 1 November 2021

Figure 1: As per World Bank Data



There is very little research on corporate governance w.r.t Indian banks. The Indian banking system in recent times has seen gigantic loss in major banks like YES bank, Punjab & Maharashtra bank, ICICI, Punjab National Bank, etc. When we look at the recent yes bank failure we come to know that the bank under-reported its NPA and asset quality numbers by 5% and it was later found that there was corporate governance issues in the bank which lead to such a scenario, the bank afterwards received assistance from State Bank of India. There are several banks whose failure is because of ballooning of non-performing assets, frauds and lack of corporate governance & transparency and they might not get proper guidance in such situation most of the time, such banks should have adhered to corporate governance rules and they could have avoided this fiasco. A single bank failure can set off a chain reaction of failures throughout the economy. This is due to the fact that, unlike other businesses, banks interdependent with one another more often. As a result, the requirement and relevance of implementing effective corporate governance is critical in terms of improving the country's financial system.

Figure 2: As Per RBI Data

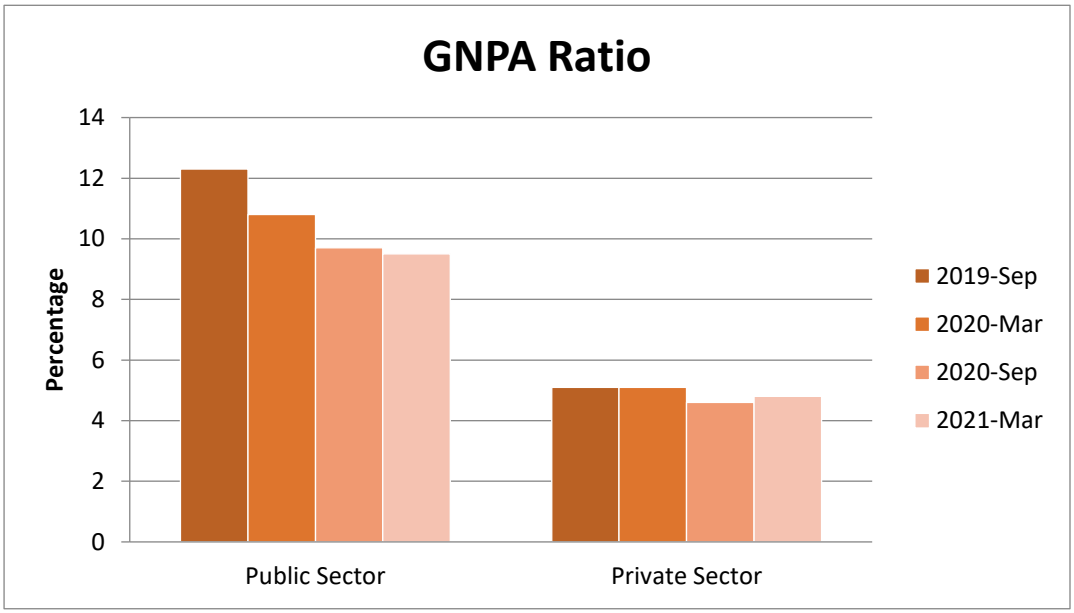
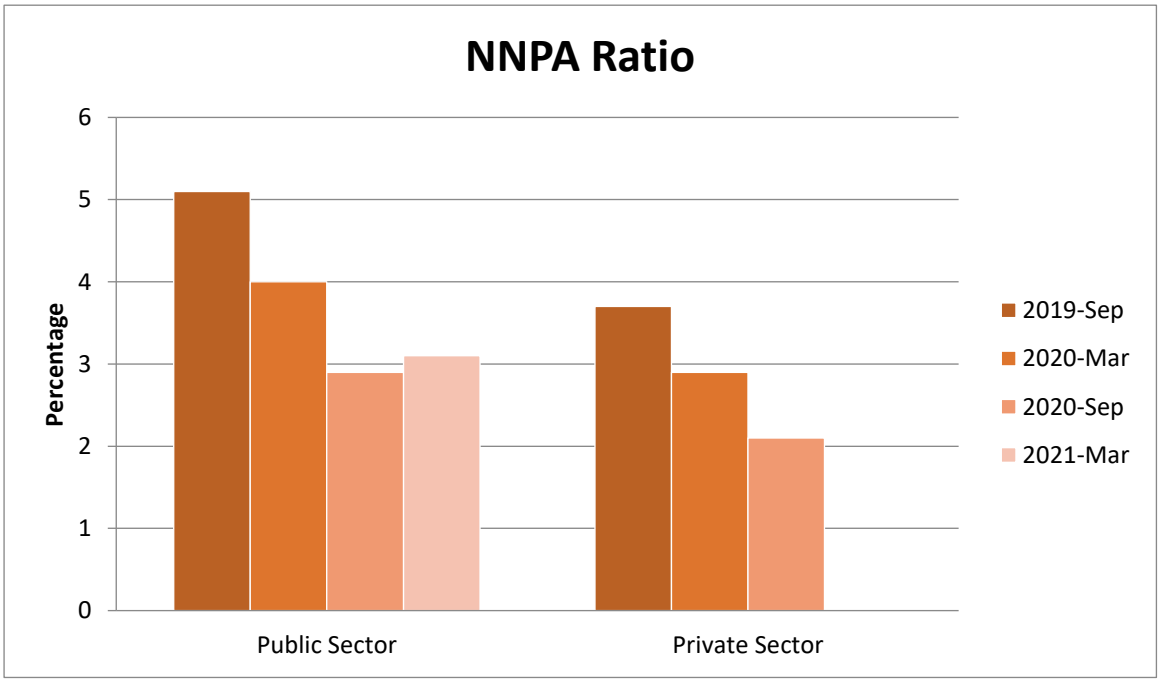


Figure 3: As per RBI Data



The Banking sector in India can no longer afford to have inadequate corporate governance. Instead of appointing retired persons, the bank's board should be comprised of independent members and qualified people having experience in banking and finance. The findings of a study which examines the relation between Corporate Governance and Banks performance, shows that increase in board size has positive impact on bank performance, but somehow it

decreases the input of that additional director.[6] But when we take a look at literature review the study shows a positive impact of corporate governance in banks performance in china, but the same somewhat has a negative impact on banks of India. This is solely due to the fact, Indian Banks are not taking or adopting corporate governance practices as a whole, banks are just fulfilling the checklist or adhering it for name sake. The chairman of ICBC stated that effective corporate governance helps to minimize non-performing loans and improve asset quality.[7]

Ownership and Bank Performance

The public sector banks of India have performed admirably and are a point ahead in financial performance as compared to private banks. But private sector banks have less non-performing assets as compared to public sector banks and a decrease in nonperforming assets (NPAs) implies that a bank's credit evaluation systems have improved over time. A study showed that corporate governance variables like board size, existence of audit committee and size of bank has a significant impact on profits of the banks.[8]

Table 1-As Per RBI Data

Market Share in Loans (%)		
Year	Public Sector Banks	Private Sector Banks
2000	79.41	12.56
2005	74.25	19.21
2010	77.24	18.08
2015	74.28	21.26
2020	59.8	36.04

[6] Kathuria, V., & Dash, S. 'Board size and corporate financial performance: An investigation' (1999) Vol. pp.11-17 Vikalpa

[7] Sahu M. 'Impact of Corporate Governance Practices on Non-Performing Assets (NPA) Management in Indian Public and Private Sector Banks' (2017) Volume 10 (4) Pacific Business Review International < http://www.pbr.co.in/2017/2017_month/Oct/8.pdf> accessed 20 November 2021

[8] Fanta, A. B. 'Corporate Governance and impact on Bank Performance' (2013) 1(1) 19 Journal of Finance and Accounting < https://doi.org/10.11648/j.jfa.20130101.12> accessed 25 October 2021

Table 2- As per RBI Data

Market Share in Depsosits (%)		
Year	Public Sector Banks	Private Sector Banks
2000	81.29	12.63
2005	78.16	17.12
2010	77.68	17.31
2015	76.26	19.44
2020	64.75	30.35

From Table 1 and Table 2 we can see that public sector banks used to have more than 70% share in the market with respect to both loans and deposits. But gradually their share has been decreased and private sector banks with its performance have managed to capture more than 30% share in both loans and deposits. Bank performance might be measured using ownership as a metric. In comparison to government-controlled banks, privately held and managed banks have stronger control over their corporate governance compliance, and there is a substantial connection between promoter holdings and corporate governance compliance. The ownership structure plays an important role and it is directly related to the NPA performance of the bank. A study found a clear link between day-to-day activity and corporate governance compliance measures. Former deputy Mr. Chakrobaty of RBI said, that in the case of private sector bank, corporate governance, accountability, and executive standards are essential to reduce the non-performing asset crisis. Furthermore, Public sector banks are highly dependent on the government for infusion of funds and thus private sector is easily able to increase its market share in both loans and deposits. The only leading public sector bank in India is State Bank of India which is functioning effectively and efficiently and next in line is private bank i.e., HDFC Bank. Both of the banks have impeccable corporate governance compliance. After the implementation of Clause 49, there is a significant increase in the severity of penalties for non compliance, Indian corporations now work towards having a high degree of compliance with corporate governance disclosure standards. A study also found that government-controlled

businesses have a lower degree of compliance than privately held businesses.[9]

Board Structure and Bank Performance

Board comprises of members who are in a combination of internal and external directors, frequently as a result of legislation or regulatory requirements. Internal directors are necessary to oversee the day-to-day operations of the company and an external director plays an important role as they provide independent view about the overall functioning of the company. The Indian legislature does not provide a proper structure to be followed by the banks it just provide the minimum requirement, furthermore as per UK corporate code, "The board should comprise of sufficient members to meet the business's needs and to handle changes to the board's composition and that of its committees without excessive disruption, but not so big that it becomes burdensome."

According to the findings of a study, which included a sample size of 38 banks, it was concluded that a higher board size enhances the effectiveness of private banks but decreases the effectiveness of the public sector banks, as public sector banks have high level of profit inefficiency, which indicates there is mismanagement of the profits in public banks. It also suggested that the ideal board size is 10.47. It was also found that private sector banks are successful in recruiting female members to the board who are able to create an impact on the bank's overall success effectively and efficiently and public sector banks are just increasing up the numbers to fulfill the criterion rather than recruiting skilled members to boost the bank's performance.

As independence of board is concerned it was found that in private sector banks, the ratio of independent directors is 2.5 times that of public sector banks. When a sample of companies from various nations was examined, it was shown that there exists a mixed relationship between the number of independent directors and bank performance. Independent directors have a vested interest in promoting and protecting the interests of shareholders, as well as serving as strong management monitors.[10] In china independent directors have a beneficial

[9] The Hindu Business line bureau 'Board size matters for better performance of banks: study' The Business line (28th October 2020)

[10] Sarkar J. & Sarkar S. 'Bank Ownership, Board Characteristics and Performance: Evidence from Commercial Banks in India' (2018) vol. 6(1) pp.17 International Journal of Financial Studies. <DOI:10.3390/ijfs6010017> accessed 20 October 2021

impact on banks profitability.[11]

In India there is a substantial ownership impact with board independence and a considerable positive link with private sector efficiency and a significant but negative link with public sector performance. This calls for enhancing the composition of the board of directors of the public sector. Thus, it can be said that appointing outside directors in India is seen favorable and it results in higher stock returns.[12]As compared to other businesses, banks must safeguard a significantly larger group of stakeholders, who do not normally have a say in how the banks conduct their operations. This necessitates the Board's engagement in strategic problems and risk supervision to a far greater extent, as it must fully comprehend the risks that the bank faces and be able to successfully monitor them and the need for expertise of board also comes into picture. This may be accomplished through committees that offer the Board with required and effective assistance in areas like as audit, risk management, nomination and remuneration, stakeholder engagement, and so on. In our sample study of 6 banks a proper balance of executive and non-executive director is maintained.

Risk Management and Bank Performance

The primary goal of corporate governance in banks is to safeguard stakeholders' interests against risk. Risk management has become increasingly crucial during times of crisis to preserve consumer trust and sustain the financial system's stability. The key for retaining financial stability is assessing the immediate, medium, and long-term impact on various sectors and establishing a strategy response built on adjustments to risk management approaches, procedures, and systems. For risk analysis, banks have to do adequate risk identification, classify the risks and establish a proper and requisite management and technical skill set. A robust risk management system helps banks in improving its credit growth quality, assures equal credit risk management skills deployment, and improves risk appetite of the bank. This will help banks to nurture and establish mutually beneficial relationships with consumers by adopting scientific risk management approaches, which will not only increase revenues and

[11]Liu, Y., Miletkov, M.K., Wei, Z. and Yang, T. 'Board independence and firm performance in China' (2015) vol.30 (C) pp.223-244 Journal of Corporate Finance <DOI:10.1016/j.irfa.2011.11.002> accessed 13 October 2021

[12] Fuzi, S. F S, Rahim, M. and Tan, A. 'Factors influencing Performance of Independent Directors in Malaysia' (2012) Sciences and Engineering Research < DOI:10.1016/S2212-5671(16)30152-6 > accessed 19 November 2021

credit management operations but create trust among the customers and create better public image[13].

The OCED Principles which is used in a number of government legislation also helps in controlling risk management in financial sector, resulting in a healthy corporate governance culture in banks. Furthermore, CAMEL model is also adopted by banks to monitor its risk. While examining the data from a study on the impact of credit risk and profitability of commercial banks it was found that the dependent variables are return on equity and return on assets, whereas the independent variables are capital adequacy ratio and non performing loan ratio, and it shows a favorable link between credit risks and profitability and negative link between non performing loan ratio and return on equity, as well as a negative correlation was also found between non performing loan ratio and return on assets. Thus, there exists a positive relation between credit risks and profitability of the banks.

Fraud Risk Management

The concept for fraud risk management emphasizes on fraud prevention, early detection, and timely reporting of fraud in an organization. Frauds can lead to the downfall of a company, significant financial losses, imprisonment and portray a bad image of the company in the eyes of public i.e. tarnish the bank reputation and repeal future customer. Frauds in banking sector leads to increase expenditure in operational expenses and it damages customer relationship. The rise in customer dissatisfaction affects banks performance. [14]Hence, the need for fraud risk management arises in banking sector. With the growing number of fraud cases due to directors of Yes Bank, PMC, ICICI, Lakshmi Vilas Bank and officials being involved in money laundering in numerous banks, exposes Indian banks weak corporate governance structure and creates a red flag, this could have been avoided by having strong internal control checks, early detection and prevention of fraud and better audit governance. Table 3 shows us that frauds are more committed in public sector banks as compared to private sector banks. But there has been a decrease in fraud in public sector banks as the banks have paid more attention to vigilance, reporting, early detection of frauds and investigation.[15] There is a need for uniform fraud risk

[13] Subramanya S.'Bank Risk Management is the need of the hour. Southern Economist Monthly' (1998) vol.37(7) p.1

[14] Hoffmann A, Birnbrich C. 'The impact of fraud prevention on bank-customer relationships: An empirical investigation in retail banking' (2012) Vol 30(5) pp.390-407 International Journal of Bank Marketing

[15] Gosh T.P. https://www.nibmindia.org/static/Prajnan/2122/AprilJune/PDF%20for%20Press/T%20P%20Ghosh%207399.pdf

management framework in India.

Table 3: As per RBI report

Year	Public Sector		Private Sector	
	No. of frauds	**Amt Involved (in Rs. Cr)**	**No. of frauds**	**Amt Involved (in Rs. Cr)**
2018-19	3568	63283	2286	6742
2019-20	4413	148400	3006	34211
Apr-June 2019	1133	31894	601	8503
Apr-June 2020	745	19958	664	8009

Audit committee and Bank Performance

The nexus between audit committee and bank performance is that audit committees constitute personnel having more exposure and expertise highly influence the banks performance. Internal and statutory auditors both play an important role as they both examine the accounts of the bank and provide the true financial image of the bank. An audit committee comprises of independent members who have an experience in the varied fields of law, accounts, economics, etc and they enhance the functioning of the bank as they provide reliable accounting data. Some argue that a larger audit committee is more effective[16], while others argue that small size audit committee with more exposure and experience are more beneficial to business performance, and that the size of the audit committee has a substantial relationship with performance of the bank.[17] ICICI bank and SBI and HDFC bank has the highest percentage of independence in

[16] Hamdan, Noora & McKnight, Patrick 'Review of Flipped Learning' (2013) <https://www.researchgate.net/publication/338804273_Review_of_Flipped_Learning> accessed 10 November 2021

[17] Zraiq M.A.A., Fadzil F.H.B. 'The impact of audit committee characteristics on firm performance: evidence from Jordan' (2018) Vol.1 (5) pp.39-42 Appl Sci <https://www.researchgate.net/publication/327665598_The_Impact_of_Audit_Committee_Characteristics_on_Firm_Performance_Evidence_from_Jordan_Article_Information> accessed 10 November 2021

their audit committee and which is 100% independence is seen in both ICICI and HDFC. In public sector bank PNB does not even have a chairman for the committee, later on they appointed the chairperson, and bank of baroda is complying with the audit committee framework. The public sector can perform better with complying with the requirements and increasing the independence in their committee.

Conclusion

A comprehensive examination of both public and private sector bank corporate governance practices reveals that private bank corporate governance is more satisfactory than public bank corporate governance, with only SBI in the public sector adhering to corporate governance practices and using them to improve its performance. Each bank's approach in a few areas is more satisfactory than the counterpart's, but both public and private sector banks have space and potential for development in other areas of disclosure. The implementation of corporate governance by HDFC bank is successful; SBI also has solid corporate practices, however it falls short in several areas when compared to HDFC. It may be stated that Indian private banks' disclosure practices assist stakeholders in making informed decisions regarding their bank's performance. Every year, corporate governance practices in India improve, notably in the banking sector, which is a positive indicator for the business. The Indian banking corporate scenario would evolve to the predicted level if other banks follow the same path.

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