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AN EMPIRICAL ANALYSIS ON CORPORATE GOVERNANCE POLICIES AND PRACTICES IN INDIAN BANKING SECTORS: A CASE STUDY OF COMMERCIAL BANKS IN INDIA

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An Empirical Analysis on Corporate Governance Policies and Practices in Indian Banking Sectors: A Case Study of Commercial Banks in India

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Abstract* – *Corporate Governance has fast emerged as a benchmark for judging corporate excellence in the context of national and international business practices. From guidelines and desirable code of conduct some decade ago, corporate governance is now recognized as a paradigm for improving competitiveness and enhancing efficiency and thus improving investors' confidence and accessing capital, both domestic as well as foreign. What is important is that corporate governance has become a dynamic concept and not static one.

Sound Corporate Governance Policies are important to the creation of shareholders value and maintaining the confidence of customers and investors alike. The Bank's Corporate Governance Policies are designed to ensure the independence of the Board of Directors (BoDs) and its ability to effectively supervise management's operation of the Bank. This paper examines the Corporate Governance Policies of Commercial banks in India which are classified into Public Sector Banks and Private Sector Banks. Private Sector banks are further classified into Old Private Sector Banks and New Private Sector Banks in the study. The Governance Policies have been assessed with the help of five parameters namely, Reasons for the written code of Corporate Governance, Availability of Corporate Governance Policies, Distribution of Related Material to concerned parties, Issues in Code of conduct and Other components of Corporate Governance. Moreover, the study empirically tests the difference in the Corporate Governance Policies between the Public Sector banks and Private Sectors banks; and, also between the Old Private Sector Banks and New Private Sector Banks in India.

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INTRODUCTION

In several parts of the world financial institutions have faced challenging times in the recent past. The most affected have been banks which have suffered losses and even closures. A major cause of the problem has been traced to low quality assets in their portfolios that turned toxic which eroded their capital and weakened their ability to perform their intermediation function. The unpalatable outcome has been loss of confidence in the banking system with dire consequences for economic management. Without doubt, there has been a failure of corporate governance. According to Cocris & Ungureanu (2007) banks are special and their corporate governance systems are of major importance because banks have a critical position in the development of economies due to their major role in running the financial system.

The banking industry is unique because it is simultaneously consolidating and diversifying. There is a significant public dimension to the banking firms; bank managers function in the light of two distinct sets of interests: one is the private interest, internal to the firm, and the other is the public interest, external to the firm. The authors report that sound corporate governance system of banks increases the efficiency of firms and also enhances the credibility of the banking industry, which has positive economic effects and countries that adopt regulation on forcing the disclosure of accurate, comparable information about banks tend to have better developed banks. Corporate Governance is concerned with the functioning of Board of Directors (BODs) –its structure, styles, process, their relationships and roles, activities etc.

Therefore, Boards of directors (BODs) is considered as a crucial part of the Corporate Governance. Directors are appointed by the shareholders of the company, who set overall policy for the company, and the board appoints one or more of them as managing directors/whole time directors/ executive directors to be approved by the shareholders. They are a link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers).The board's primary role is to monitor management on behalf of the shareholders. Board of directors is the important element of Corporate Governance. Corporate Governance addresses the issues facing Boards of Directors. In this view, the main responsibility of governing a company is upon the Board of Directors and, therefore, attention must be paid to their roles and responsibilities. The roles of the Board of Directors and shareholders are interactive and, therefore, the quality of governance depends upon the level of interface set up by them. The boards are accountable in many ways to the shareholders and stakeholders in a company. The directors are required to attain a balance between competing interests

of shareholders, customers, lenders, promoters and directors. Preferably, the board should be the heart and soul of a company. Whether or not, the company grows or declines, depends upon the sense of purpose and direction, the values, the will to generate stakeholders' satisfaction and the drive to achieve them.

Section 2(13) of the Indian Companies Act 1956 defines a director as follows, "A director includes any person occupying the position of director by whatever name called. The important factor to determine whether a person is or is not a director is to refer to the nature of the office and its duties. It does not matter by what name he is called. If he performs the functions of a director, he would be termed as a director in the eyes of the law, even though he may be named differently. A director may, therefore, be defined as a person having control over the direction, conduct, management or superintendence of the affairs of a company. Again, any person in accordance with whose directions or instructions, the board of directors of a company is accustomed to act is deemed to be a director of the company." Section 2(6) of the Indian Companies Act 1956 states that directors are collectively referred to as "Board of Directors" or simply the "Board". A director may be a full time working director, namely managing or whole time director covered by a service contract. Managing and whole time directors are in charge of the day-to-day conduct of the affairs of a company and are together with other team members collectively known as "management" of the company. A company may also have non-executive directors who do not have anything to do with the day-to-day management of the company. They may attend board meetings and meetings of committees of the board in which they are members.

As per clause 49 of the Securities and Exchange Board of India (SEBI)'s listing agreement, there is one more category of directors called Independent Directors. An Independent Director is defined as a "non-executive director who is free from any business or other relationship which could materially interfere with the exercise of his independent judgment. Another category of directors recognized in certain provisions of the Indian Companies Act 1956 are "Shadow Directors". These so called "deemed directors" acquire their status by virtue of their giving instructions (other than professional advices) according to which "appointed" directors are accustomed to act. Board of directors is there for governance of the company and it performs the strategy making role. Hence, it should have a right mix of outsiders and people from the management so that people who execute the decisions have a say in decision making in parallel ensuring that the stakeholder's interests are protected. Clause 49 of the Securities and Exchange Board of India's (SEBI) listing agreement requires that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors and further that where the Chairman is a non-executive director, at least one-third of board should comprise of independent directors and in case he is an executive director, at least half of board should comprise of independent directors. The said Clause also sets out the principles for determining "independent director". The said Clause also provides that nominee directors appointed by an investing or lending institution shall be deemed to be independent directors. The size of the Board should neither be too small nor too big. Experience indicates that smaller boards allow for real strategic discussion.

At the same time, larger Boards provide the benefit of diverse experience and viewpoints. The board should strike a balance of executive and non-executive directors. Every board should consider whether its size, diversity and demographics make it effective. Diversity applies to academic qualifications, technical expertise, relevant industry knowledge, experience, nationality, age and sex. Diversity adds value, and adds to the bottom line. Gender diversity is an important aspect of board diversity and companies should have women representation on the Boards. Boards need to be regularly refreshed with new expertise, energy and experience. Independent directors should not have long tenure.

A balance should be sought between continuity in board membership, subject to performance and eligibility for re-election and the sourcing of new ideas through the introduction of new board members. Every Company should frame a Board Renewal Policy of Independent Directors to facilitate their independence. The policy may provide for maximum number of years a person could serve on the Board as an Independent Director. The role and office of the Chairman and CEO should be separated to promote balance of power and to prevent unfettered decision making power with a single individual. Further, there should be a clear demarcation of the role and responsibilities of Chairman and Managing Director/Chief Executive Officer (CEO).

BACKGROUND

The subjective evidence of the 1997 Asian crisis showed that poor corporate governance contributed to the collapse of many banks and corporate firms in Thailand, Malaysia, South Korea and Indonesia. Since then, there has been a sincere effort to improve corporate governance in the crisis ridden countries. The financial crisis in some Asian countries in late 1990s prompted most of the countries to give improved corporate governance a priority. ―The losses due to weak corporate governance practices and corruption are estimated at nearly 15 percent of China‗s GDP, though the figure may be much higher‖. An annual collaborative study of the corporate governance landscape of Asian markets titled "Spreading the World: CG Watch 2004-05" was undertaken by independent stockbrokers. From this forum the awareness and importance of corporate governance in Asian countries was realized. Asian countries do realize that CG practices would not change overnight; hence patience is the key to success in this field.

Considering the importance of this subject, Asian Corporate Governance Association (ACGA), made a report during 2004-05, on the state of affairs of corporate governance in Asian markets, emphasizing on some key determinants behind assessing corporate governance standards such as rules and regulations, enforcement, political and regulatory environment, the adoption of international accounting standards, and corporate governance culture.

In India Corporate governance has most recently been debated after the corporate fraud by Satyam founder and Chairman Ramalinga Raju. In fact, trouble started brewing at Satyam around December 16, 2008 when Satyam announced its decision to buy stakes in Maytas Properties and Infrastructure for $1.3 billion. The deal was soon called off owing to major discontentment on the part of shareholders and plummeting share-price. However, in what has been seen as one of the largest corporate frauds in India, Raju confessed that the profits in the Satyam books had been inflated and that the cash reserve with the company was minimal. Ironically, Satyam had received the Golden Peacock Global Award for Excellence in Corporate Governance in September 2008 but was stripped of it soon after Raju's confession.

Corporate governance has been on the top priority of Asian countries with most markets introducing comprehensive regulations. Although it cannot be called a fully satisfied accomplishment from the evidence of its achievements, but the ethos of corporate governance is yet to come out fully. During the same period, the need for corporate governance was also felt in line with the international trend. The first initiative for ensuring corporate governance among Indian companies came from the corporate sector itself. The Confederation of Indian Industry (CII) came up with the Code of Desirable Corporate Governance in 1998. Then the Securities Exchange Commission of India (SEBI) which is the regulator of Indian financial market, appointed 'Kumaramangalam Birla Corporate Governance Committee'. Most of the recommendations made by the Committee were accepted and implemented by SEBI in the year 2000.

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CORPORATE GOVERNANCE IN INDIAN CONTEXT

In the Indian context, the need for corporate governance has been highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991 such as the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum.

From the beginning of 1980s, situations have changed in India. There have been wide-ranging changes has taken place in both the laws and the regulations in the field of corporate law and the capital market. As a result of several scams in India a need has arisen to bring reforms, in response to that, reforms began in 1991 in India. The most important event in the field of investor protection in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992.

Corporate governance is a multi-faceted subject. An important theme of corporate governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare.

In India the concept of corporate governance is gaining importance because of two reasons.

- After liberalization, there has been institutionalization of financial markets, FIIs and FIs became dominant players in the stock markets. The market began to discriminate between wealth destroyers. Corporate governance is a critical by product of market discipline.

- Another factor is the increased role being played by the private sector. Companies are realizing that investors love to stay with those corporate that create values for their investors.

This is only possible by adopting fair, honest and transparent corporate practices.

LITERATURE REVIEW

According to Cocris & Ungureanu (2007) banks are special and their corporate governance systems are of major importance because banks have a critical position in the development of economies due to their major role in running the financial system. The banking industry is unique because it is simultaneously consolidating and diversifying. There is a significant public dimension to the banking firms; bank managers function in the light of two distinct sets of interests: one is the private interest, internal to the firm, and the other is the public interest, external to the firm. This study emphasizes the implications of banks' specific attributes on their corporate governance framework viz. greater opaqueness and greater regulation from the point of view of current economic framework and further it analyses the environment with increased regulation of the banking firm, as a governance control mechanism. The authors report that sound corporate governance system of banks increases the efficiency of firms and also enhances the credibility of the banking industry, which has positive economic effects and countries that adopt regulation on forcing the disclosure of accurate, comparable information about banks tend to have better developed banks. These policies enhance the operations and governance of banks. The authors opine that banks, nowadays, respond to tight regulation through mechanisms such as financial innovation, securitization, globalization and new technologies, if these responses are managed adequately, they may have stimulating effects on the governance of banks. Levine (2004), discusses two special attributes of banks that make them special in practice: greater opaqueness than other industries and greater government regulation. These attributes weaken many traditional governance mechanisms. Next, the study reviews emerging evidence on which government policies enhance the governance of banks and draws tentative policy lessons. In sum, he concludes that the existing work suggests that it is important to strengthen the ability and incentives of private investors to exert governance over banks rather than relying excessively on government regulators.

Arun and Turner (2004) discuss the corporate governance of banking institutions in developing economies. Based on a theoretical discussion of the corporate governance of banks, authors suggest that banking reforms can only be fully implemented once a prudential regulatory system is in place. An integral part of banking reforms in developing economies is the privatization of banks; so the corporate governance reforms may be a prerequisite for the successful divestiture of government ownership. Furthermore, authors opine that the increased competition resulting from the entrance of foreign banks may improve the corporate governance of developing-economy banks. Chahine and Safieddine (2009) provide new insights into the effect of corporate governance in emerging markets by examining the banking system in Lebanon. This research shows that board characteristics influence bank conduct and performance. Using a sample of 749 firm years of unbalanced panel data on the banking industry in Lebanon from 1992 to 2006, this paper shows that bank performance, as measured by Return on Assets and the Return on Equity, have a positive association with board size. It also identifies a quadratic relationship between bank performance and board independence as both Return-on-Assets and Return-on-Equity first decrease and then increase in direct proportion to the increased percentage of outside directors on the board. This study sheds some light on the differential impact of corporate governance on firm performance across industries and countries. It concentrates on banks in developing countries that are generally known to suffer from high asymmetric information and where concerns about safety and soundness remain. Hence, it contributes to the existing debate on appropriate regulations for an effective and stable financial system in the Arab World. Also, it complements the Basel Committee standards for bank supervision and capital adequacy reinforcement, and offers regulators some evidence on the relationship between board size and bank performance in a developing country such as Lebanon. Asian roundtable on corporate governance (2006) identifies corporate governance that affects Asian banks and finds that banking sector in many Asian jurisdictions do not have, in place, sufficient institutional infrastructure necessary for effective enforcement of the corporate governance of the corporate policy framework. The members of the Task Force believe that Asian banks play a dominant role in regional finance due to the immature capital markets, and Asian policy makers should be aware that sound corporate governance of banks cannot be developed effectively without tackling institutional constraints and weaknesses. The Task Force recommends that Asian banking supervisors should take the lead to improve corporate governance of banks in Asia. They believe that banking supervisors in all Asian Jurisdictions, in conjunction with securities regulators and stock exchanges, should develop national codes of corporate governance of banks, a template on which banks should base the development of their own codes respectively, based in turn on the conditions of each jurisdiction and on existing corporate governance codes. Furthermore, banking supervisors should develop rating mechanisms for corporate governance of banks so that banks can improve their corporate governance framework time and again.

Pati (2006) explains that policy framework for corporate governance has been developed lately in India and for banking it is still evolving. For Indian banking the RBI has taken the sole responsibility of framing policy in this regard. The Standing Committee on International Financial Standards and Codes which was set up in 1999 to bring common financial standards in line with international practices constituted an advisory committee on corporate governance under the chairmanship of R.H. Patil. The sub-committee submitted its report in 2001; and in this report it has been observed that since most of the Indian companies belong to the “insider” model of East Asia i.e. dominance of family/promoter ownership and control, it is essential to bring quick reforms in corporates/banks/financial institutions/public sector enterprises to make them more autonomous and professional. The Group looked into public sector 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 board 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. Further, the RBI constituted a Consultative Group of Directors of Banks and Financial Institutions under the Chairmanship of Dr. A.S. Ganguly to review the supervisory role of boards of banks and FIs. This 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 other steps taken by RBI in respect of corporate governance in the Indian Banking System are classified into three categories viz., a) Transparency b) Off-site surveillance and c) Prompt corrective action. The author surveys that the post implementation scenario of corporate governance policies in Indian banking has brought mixed outcomes. Along with qualitative changes in disclosure practices most of the banks have shown handsome profit and low NPAs. Statistically significant correlations of governance with important financial variables on expected lines have been found for banking in India.

METHODOLOGY

The present study is empirical in nature that examines the Corporate Governance Practices in Indian commercial banks. In order to complete the study, data has been collected from both Primary as well as secondary sources. Secondary data are based on official records, annual reports, journals and books. The primary data are collected through well designed questionnaire which has been administered to the officers and managers of the banks concerned.

Questionnaire Design - The questionnaire used for the study aims at the Corporate Governance Policies of Indian commercial banks with the help of four constructs viz., Reasons for the written code of Corporate Governance, Availability of Corporate Governance Policies, Distribution of Related Material to concerned parties, Issues in the Code of Conduct and Other Components of Corporate Governance. The questionnaire that has been used in this study was developed and used by Tandelilin, Kaaro, Mahadwartha, Supriyatna (2007). In the questionnaire, there are only close ended questions which are measured with the help of 5 point Likert scale with the scores ranging from 1 = Strongly Disagree, 2 = Disagree, 3 = Neither Agree, Nor Disagree, 4 = Agree and 5 = Strongly Agree.

Sample Selection - The universe of the study consists of 96 Commercial Banks operating in India, out of which 27 are Public Sector Banks, 31 Private Sector Banks and 38 Foreign Banks. Initially, the present study aimed to study all the commercial banks (96) and accordingly 96 questionnaires were delivered to all commercial banks through email and by personally visiting them.

Statistical Tools and Techniques used to analyze the data - The assessment of Corporate Governance Practices has been done with the help of following statistical tools and techniques:

- Average (Mean)
- Standard Deviation
- T- Test has been used for hypotheses testing

CONCLUSION

The Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and financial markets acquire greater depth. There is an assurance that the policy environment will remain supportive of healthy growth and development with accent on more operational flexibility as well as greater prudential regulation and supervision. In all the regards, the big banks will have the marked advantage over the small and medium sized banks. This might lead to considerable level of consolidation in the Indian Banking Industry. Indian banks are far behind their foreign

counterparts in disclosing information to the public. Wake of increased competition from foreign banks, disclosure norms can serve to be important differentiating factor to attract and retain big corporate clients. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newlyemerging business areas like micro finance, commitment to better customer service, adequate automation and proactive policies on house-keeping issues, banks will definitely be able to grapple with these challenges and convert them into opportunities.

The Indian banking system is among the healthier performers in the world. 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. Since banks are important players in the Indian financial system, special focus on the Corporate Governance in the banking sector becomes critical.

Corporate Governance Policies of each company have been evolved and adopted from time to time in view of the legal and cultural scenarios in which these companies are operating. In India, the Corporate Governance Policies are framed in the light of Companies Act and Clause 49 of SEBI's listing agreement. Sound Corporate Governance Policies are important to the creation of shareholders value and maintaining the confidence of customers and investors alike. In today's dynamic corporate world Commercial Banks in India needs to adopt and strengthen the corporate governance policies not only to boost and enhance pecuniary benefits but as a path to gaining public image, thus recognised by the society in which the bank operates as socially receptive commercial bank(s) which may augment the banks operations and survival.

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