DISCLOSURE OF CORPORATE GOVERNANCE IN BANKS AND ITS IMPACT ON SELECT PERFORMANCE PARAMETERS

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"Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations. Capital flowed towards companies that practiced this type of good governance" Mervyn King (Chairman: King Report)[1]

The concept of ***"Governance"*** is as old as human civilization. In simple terms, ***"Governance"*** means the process of decision making and the process by which decisions are implemented (or not implemented). Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. Corporate Governance is a means to an end, the end being long term shareholder, and more importantly, stakeholder value.

Corporate Governance has been defined by many renowned Scholars and Institutions. A few of such definitions of Corporate Governance will give us a better understanding of the concepts from all possible perspectives.

J. Wolfensohn, president of the World bank, quotes[2] *"Corporate Governance is about promoting corporate fairness, transparency and accountability"*

Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000 [3] has rightly said *"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society"*

Margaret Blair, in her book, 'Ownership and Control' – Rethinking Corporate Governance for the Twenty-first Century, 1995[4]**,** describes Corporate Governance as about *"the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated."*

Thus it can be said that Corporate Governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. It also includes the relationships among the many players involved, that is, the stakeholders, and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

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1 Retrieved from http://www.corporate-governance.co.za/Home/CorporateGovernanceQuotes/tabid/148

2 Financial Times, June 21, 1999) retrieved from www.heritageinstitute.com/ **governance**/definitions.html

3 Retrieved from www.corpgov.net/library/definitions.html

4 Retrieved from www.corpgov.net/library/definitions.html

Banks are a critical component of the economy as they are the providers of finance to the industry and trade. Their importance can also be understood by the fact that they are the most regulated, at the same time most protected. Banks in a broad sense are institutions whose business is handling other people's money[1.] Banks are corporations themselves. It is therefore very important that banks have strong Corporate Governance practices. Banks' Corporate Governance gets reflected in Corporate Governance of firms they lend to. Thus, governance of banks is crucial for growth and development of the economy.

Corporate governance and firm performance

Research into the relationship between specific corporate governance controls and firm performance has been mixed and often weak. McKinsey Global Institute, in its 'Global Investor Opinion Survey'[6] of over 200 institutional investors first undertaken in 2000 and updated in 2002, found that 80% of the respondents would pay a premium for well-governed companies. Other studies have linked broad perceptions of the quality of companies to superior share price performance.

Conceptual Framework and Definitions of Terms

The framework of research for the purpose of this article seeks to understand the corporate governance disclosure practices of banks in the first part of the study. Then it tries to link corporate governance mechanisms with the performance of banks. Corporate governance mechanisms include internal mechanisms designed to reduce the inefficiencies of the organization due to the separation of ownership and control. The internal mechanisms include ten dimensions, namely, Governance philosophy of the company, Board of directors, Audit committee, Remuneration committee, Shareholders' committee, General body meeting, Disclosures, Means of communication, General shareholder information and Non-Mandatory Requirements. Similar conceptual framework has been used in various other studies. Klapper and Love (2004), Durnev and Kim (2005), Muhammed Hossain (2004)

Operational definitions of Corporate Governance Score

Corporate Governance Score: is an unweighted disclosure index**.** This approach is adopted in the study as other researchers used this approach. (Wallace, 1987; Cooke, 1991 and 1992; Karim, 1995; Hossain et al., 1994; Ahmed and Nicholls, 1994; and Hossain, 1999. **It is calculated using a simple formula:**

$$\text{CG Score} = \Sigma di$$

where di=1 if the item of governance is displayed and di=0 if it is not displayed. All the items of disclosure are given equal weights, indicating equal importance.

Time frame

Years 2004-05 and 2005-06 are considered as the pre compulsion period (when it was not compulsory for banks and other corporations to disclose a report on corporate governance). The period comprising of 2006-07, 2007-08 and 2008-09 is considered as the post compulsion period (when it was made compulsory for banks and other corporations to disclose a report on corporate governance).

The specific objective of the research paper is to perform an analytical comparison between corporate governance score and bank performance as per books of accounts.

The following null hypotheses were set up to test the relationship between corporate governance score and bank performance.

Corporate governance disclosure has no impact on

- Return on Average Assets of a bank.
- Return on Total market Value of Shares of a bank.
- Net Profit (Crores) of a bank.
- Earnings Per Share (Rs) of a bank.
- Amount Paid as Penalties and Strictures of a bank.
- Foreign investment of a bank.

[5] Greener, Michael The penguin dictionary of Commerce,(1973) Reprints

[6] Retrieved from www.ashgatepublishing.com/.../Global_Perspectives_Corporate_Governance_CSR_Ch1

Limitations of the Study

(i) As good governance is still hard to gauge, complying with all the rules do not necessarily mean a firm is being well run.

(ii) It is assumed that Governance and Performance coexist on the timeline. However, good Corporate Governance and high performance of the company do not occur in the same period. Performance may have a lag effect of one to three years, but that is not established.

A thorough literature review was undertaken to get an idea about the items to be included in building a corporate governance score which would reflect the practices of the banks in relation to corporate governance. The studies which helped in this respect were:

- **Muhammed Hossain (2004)** studied the corporate governance of banks. The researcher identified 57 items of information both mandatory and non mandatory need to be disclosed under the clause 49 in the corporate governance report.
- **Klapper and Love (2004)** used a composite of 57 qualitative binary questions provided by Credit Lyonnais Securities Asia (*CSLA*) to develop their index for 14 emerging markets. These questions were in seven categories of governance: discipline, transparency, independence, accountability, responsibility, fairness, and social awareness.
- **Brown and Caylor (2004)** created a corporate governance index using data provided by 'Institutional Shareholder Services'. Their Index 'Gov-Score' was a composite measure of 51 governance provisions covering eight categories.
- **Anil Gupta, Ajit P Nair and Ratnaja GoGula (2003)** used the content analysis approach to scan Corporate Governance reporting by 30 Indian companies which form the BSE Sensex to access their adherence to SEBI regulations. The findings indicated that the firms provided the information related to all the 9 dimensions of corporate governance.

In the present study, the disclosure requirements as per the revised clause 49 of the listing agreement formed the base for building the corporate governance score. A total of 75 variables among 10 different headings-both mandatory and non-mandatory, were identified to be of importance for good governance. Thus the maximum score that any bank could secure was 75, indicating 100% disclosure and the minimum was 0 indicating 0% disclosure.

The CG Scores thus found out revealed the extent of disclosure of governance practices in banks under consideration. Major findings relating to disclosure are:

- ✓ The governance scores improved from 43.28 in 2004-05 to 55.88 in 2008-09. This is because of the compulsion imposed by SEBI for all the listed companies (including banks) to include a report on governance practices in their annual reports.
- ✓ During the study period, the disclosures relating to board of directors and shareholders' committee were the highest with 91% and 87% disclosure.
- ✓ The disclosures relating to Remuneration committee and General body meeting were the least with 40% and 42% respectively.
- ✓ The average of all the individual governance attributes increased tremendously during the post compulsion period when compared to the pre compulsion period.

The key findings relating to **changes in CG Score and performance parameters during the study period** are presented here.

Differences in CG Score and performance parameters between pre and post compulsion periods-Statistics

Performance Parameters	Pre compulsion Period (N=50)		Post compulsion period (N=75)		ANOVA		Accept/Reject H0
	Mean	Std. Deviation	Mean	Std. Deviation	F Ratio	Sig. Value	
CG SCORE	47.00	11.00	55.37	4.07	36.033	0.000	Reject H_0
Net Profit (in Crores)	712.7	902.35	1252.12	1643.18	4.479	0.036	Reject H_0
Return on Average Assets (%)	0.99	0.51	1.04	0.32	0.458	0.5	Accept H_0
EPS (in Rs)	12.02	2.38	13.02	1.92	6.6	.011	Reject H_0
Capital adequacy ratio (%)	12.02	2.38	13.02	1.9	0.94	0.334	Accept H_0
Foreign Investment (in %)	17	11	19	12	0.94	0.334	Accept H_0
Institutional Investors and Mutual funds (in %)	8	6	11	7	6.38	0.013	Reject H_0
Penalties and strictures paid to SEBI and RBI (Rs)	141304	512759	274725	2159390	0.169	0.682	Accept H_0
Nonperforming assets(% of advances)	1.26	0.8	0.87	0.6	9.513	0.003	Reject H_0

(Source**: Data collected from annual reports of banks)**

The steep growth in profit, EPS and institutional investment during the post compulsion period is an indication that making it compulsory for listed companies to disclose governance practices has, to an extent, had a positive impact on the performance of banks. This is also reflected in the decrease of Nonperforming assets.

The next part deals with the result of hypothesis testing. Here, the impacts of Governance scores on various performance parameters are depicted.

Impact of CG on performance parameters-Statistics

Model	Dependent variable	Independent variable	R	R^2	F Value	Sig Value	Accept/ reject Ho
1	Return on average assets	CG Score	0.102	0.010	1.271	0.262	Accept
2	Total market value of shares	CG Score	0.203	0.041	5.268	0.023	Reject
3	Net profit(Crores)	CG Score	0.229	0.052	6.729	0.011	Reject
4	Earnings per share (Rs)	CG Score	0.078	0.006	0.738	0.392	Accept
5	Amount paid as penalties & strictures	CG Score	0.076	0.006	0.684	0.410	Accept
6	Foreign investment (%)	CG Score	0.260	0.068	8.359	0.005	Reject

(Source: Data collected from annual reports of banks)

- ✓ Corporate governance disclosure has no impact on Return on average assets of a bank. This is the result of the regression analysis with the result: F-ratio=1.271 (less than 4) and its associated significance level=0.262 (greater than 0.05)
- ✓ Corporate governance disclosure has an impact on Total market value of shares of a bank. This is the result of the regression analysis with the result: F-ratio=5.268 (greater than 4) and its associated significance level being 0.023 (less than 0.05). thus it can be concluded that the model is statistically significant.
- ✓ Corporate governance disclosure has an impact on Net profit (Crores) of a bank. This is the result of the regression analysis with the result: F-ratio=6.729 (greater than 4) and its associated significance level being 0.011 (less than 0.05). Thus it can be concluded that the model is statistically significant.
- ✓ Corporate governance disclosure has no impact on Earnings per share (Rs) of a bank. F-ratio=0.738 (less than 4) and its associated significance level=0.392 (greater than 0.05). The model is not statistically significant.
- ✓ Corporate governance disclosure has no impact on Amount paid as penalties and strictures of a bank. F-ratio=0.684 (less than 4) and its associated significance level being 0.410 (greater than 0.05). The model is not statistically significant.
- ✓ Corporate governance disclosure has an impact on foreign investment (%) of a bank. With the F-ratio being 8.359 (greater than 4) and its associated significance level being 0.005 (less than 0.05), it can be concluded that the model is statistically significant.

Conclusion

This research set out to develop an understanding of corporate governance in the banking sector, and its effect on performance. The study was based on the compliance required by Clause 49 of the listing agreement. It first recapitulates and builds on previous works undertaken by various authorities on the subject. An enquiry into the link between governance and performance also formed a part of the study.

The efforts of the government and SEBI in making corporate governance a part of the Annual report has found tremendous success. Banks, big and small, old and new, profitable and not so profitable, are disclosing both mandatory and non-mandatory issues to a very large extent. The disclosure of governance has definitely improved significantly for all the banks under study during the post compulsion period as compared to the pre compulsion period. This is a clear indication of the fact that banks have taken it up seriously, and are positively attempting to improve the governance disclosures. During the study period, the performance parameters like Net profit, earnings per share, Institutional Investment have improved significantly, and non performing assets as a percentage of advances has come down. Thus, it can be said that there definitely is an association between good governance and improved performance of banks and this will go a long way in making it an integral aspect of management of banking institutions.

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