

Corporate governance mechanisms and financial performance of banks

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Abstract

In the present day liberalized economic environment where the countries are well integrated into the world market, the banking sector cannot ignore the importance of Corporate Governance. Better Corporate Governance necessitates the separation of ownership from management. This separation of ownership and control gives rise to agency problems. The paper discusses mechanisms and their impediments to monitor and shape banks' behaviour to deal with such problems. It reviews the theoretical framework of Corporate Governance in the light of agency theory, stakeholder theory and the stewardship theory. It also highlights the need for Corporate Governance in banking sector in general and that of India in particular. The paper makes a modest attempt to establish the linkage between Corporate Governance and financial performance with the help of past studies and suggests that banks with effective Corporate Governance mechanisms have better financial performance.

Keywords: corporate governance, financial performance, banking sector, agency theory, stakeholder theory, stewardship theory

1. Introduction

The banking system plays a pivotal role in the economic life of any country. The health of the economy is closely related to the soundness of its banking system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. The banking industry in India being the backbone of its economy and has always played a key role in preventing economic downturns. The Indian banking system is amongst the better and healthier performers in the world. Staying focused on fundamentals, adoption of utmost professionalism, conformity to prescribed norms of lending & investment, adherence to sound banking principles & ensuring optimum capital adequacy are vital for success & continued survival of banks. In the liberalized economic environment where the country is well integrated into the world market, the domestic corporate sector at present cannot ignore the importance of Corporate Governance. In the present day, Corporate Governance can be used as tool to maximize shareholders' wealth.

Meaning of Corporate Governance

Corporate Governance is a uniquely complex and multi-faceted subject. Devoid of a unified or systematic theory, its paradigm, diagnosis and solutions lie in multidisciplinary fields i.e. economics, accountancy, finance among others (Cadbury, 2002) ^[10]. As such it is essential that a comprehensive framework be codified in the accounting framework of any organization. In any organization, Corporate Governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the organization depends on the underlying soundness of its individual components and the connections between them.

As per Prowse (1995) ^[36], the major factors that support the financial stability of a nation include: good Corporate Governance; effective marketing discipline; strong prudential regulation and supervision; accurate and reliable accounting

and financial reporting systems; a sound disclosure regime and an appropriate savings deposit protection system.

Corporate Governance has been looked at and defined variedly by different scholars and practitioners. However, they all have pointed to the same end, hence giving a consensus in the definition. Coleman and Biekpe (2006) ^[30] defined Corporate Governance as the relationship of the enterprise with shareholders or in the wider sense as the relationship of the enterprise with the society as a whole. However, Mayer (2000) ^[33] offers a definition with a wider outlook and contends that it means the sum of the processes, structures and information used for directing and overseeing the management of an organization. The Organization for Economic Corporation and Development (1999) has also defined Corporate Governance as a system on the basis of which companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between the parties included (board of directors, the supervisory board, the management and shareholders) and formulate rules and procedures for adopting decisions on corporate matters. In general, we may define Corporate Governance as the mechanisms, processes and relations by which corporations are controlled and directed.

Corporate Governance Mechanisms

One consequence of the separation of ownership from management is that the day-to-day decision-making power rests with persons other than the shareholders themselves. The separation of ownership and control has given rise to an agency problem whereby there is the tendency for management to operate the firm in their own interests, rather than those of shareholders' (Jensen and Meckling, 1976; Fama and Jensen, 1983) ^[28, 17]. This creates opportunities for managers to build illegitimate empires and, in the extreme, outright expropriation. Various suggestions have been made in the literature as to how the problem can be reduced (Jensen and Meckling, 1976; and Hermalin and Weisbach, 1998) ^[28, 22].

Some of the mechanisms and their impediments to monitor and shape banks' behaviour are discussed below.

Shareholders: Shareholders play a key role in the provision of Corporate Governance. Small or diffuse shareholders exert Corporate Governance by directly voting on critical issues, such as mergers, liquidation, and fundamental changes in business strategy and indirectly by electing the boards of directors to represent their interests and oversee the myriad of managerial decisions. Incentive contracts are a common mechanism for aligning the interests of managers with those of shareholders. The Board of directors may negotiate managerial compensation with a view to achieving particular results. Thus small shareholders may exert Corporate Governance directly through their voting rights and indirectly through the board of directors elected by them.

Debt Holders: Debt purchasers provide finance in return for a promised stream of payments and a variety of other covenants relating to corporate behaviour, such as the value and risk of corporate assets. If the corporation violates these covenants or makes default on the payments, debt holders typically could obtain the rights to repossess collateral, throw the corporation into bankruptcy proceedings, vote in the decision to reorganize, and remove managers. Thus debt holders may also exert Corporate Governance directly through their legal rights if not indirectly.

Theoretical Framework for Corporate Governance

Sanda *et al.* (2010) in their work titled Corporate Governance mechanisms and firm financial performance in Nigeria identified the agency theory, stakeholder theory and the stewardship theory as the three prominent theories of Corporate Governance which are discussed below.

Stakeholder Theory: One of the original advocates of stakeholder theory, Freeman (2010) ^[19], identified the emergence of stakeholder groups as important elements to the organization requiring consideration. Freeman further suggests a re-engineering of theoretical perspectives that extends beyond the owner-manager-employee position and recognizes the numerous stakeholder groups. Freeman (2010) ^[19] defines stakeholders as any group or individual who can affect or is affected by the achievement of the organization's objectives. Freeman (1999) ^[18], suggests, if organizations want to be effective, they will pay attention to all and only those relationships that can affect or be affected by the achievement of the organization's purpose. That is, stakeholder management is fundamentally a pragmatic concept. Regardless of the content of the purpose of the firm, the effective firm will manage the relationships that are important.

Stewardship Theory: Stewardship theory suggests that directors frequently have interests that are consistent with those of shareholders. As per Donaldson and Davis (1991) ^[15], organisational role-holders are conceived as being motivated by a need to achieve and gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses. Stewardship theory holds that there is no inherent, general problem of executive motivation (Cullen *et al.*, 2006) ^[11]. Citing the work of Silverman (1971) ^[40], Donaldson and Davis argued that personal perception motivates individual calculative action by managers, thus linking individual self-esteem with corporate prestige. This would suggest that extrinsic incentive contracts

are less important where managers gain intrinsic satisfaction from performing their duties.

Agency Theory: The agency theory by far dominates the Corporate Governance literature. Daily *et al.* (2003) ^[13], point to two factors that influence the prominence of agency theory. Firstly, the theory is a conceptually simple one that reduces the corporation to two participants, managers and shareholders. Secondly, the notion of human beings as self-interested is a generally accepted idea. In its simplest form, agency theory explains the agency problems arising from the separation of ownership and control. It provides a useful way of explaining relationships where the parties' interests are at odds and can be brought more into alignment through proper monitoring and a well-planned compensation system (Davis *et al.* 1997) ^[14]. Eisenhardt (1989) ^[16] outlines two streams of agency theory that have developed over time, the principal-agent relationship where both act in concert and a positivist perspective where they are likely to have conflicting goals.

Need For Corporate Governance in Banking Sector

As we are marching forward to become a global economy, we are confronted with myriad transitional issues. These can be correctly identified as structural changes in market institutions that has brought about much awareness among investors, bankers and public at large. Despite economic reforms like privatization, liberalization and lifting the licensing raj, the economic growth has been relatively slow. Growth could not take its stand due to an unbalanced approach. The state and '*para-state*' institutions such as *privatisation funds* remain in the hands of largest shareholders of companies. As a result, the de-facto power remains loaded in the hands of a few individuals considered as internal owners, while the external owners do not have enough power to control the companies and thereby are not in a position to ensure appropriate returns for themselves (Burchard, 2011) ^[8].

Another important factor in banking industry in developing countries is that banks are mostly owned by government. In such situation, banks are mostly guided by government bodies and many laws based on stereotype procedures. The accountability idea is less apparent as the concept of government job discourages the spirit of competition. The need for Corporate Governance in developing, emerging and transitional economies not only arises from resolving problems of ownership and control, but also from ensuring transparency in achieving the desired goal of Corporate Governance. In many cases, developing and emerging economies are troubled with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing. Ownership pattern, regulatory environment, societal pressure and the broad structure would be the key elements in the design of a governance framework of banking. While government ownership does provide core strength to banks, the structural inefficiencies and lack of management autonomy appears to have weakened the ability of our banks, especially in the public sector to compete effectively in the current market situation (Indiresan, 2013) ^[26].

Banks and financial institutions have been making pivotal contributions over the years to the economic growth and development of the nation. Public sector banks have played a major role in economic development. During the last few years, these institutions are slowly getting corporatized and consequently Corporate Governance issues in banks assumes

greater significance in the coming years. Considering the importance of banking sector, the practice of Corporate Governance and how it helps in bringing more transparency and contributing to the overall growth of the sector is of great concern.

Corporate Governance in Indian Banks

In India the initial formal moves towards Corporate Governance was not due to any corporate scandal like World Com or Enron or any rule of law, however, it started as a self-regulatory move. Corporate Governance can be traced in India after the Cadbury committee report on financial aspects of Corporate Governance was released in the UK in 2002. The Confederation of Indian Industry (CII) was the first to frame the voluntary code on corporate governance in India. The next keystone in the Indian case has been the SEBI Committee chaired. The Committee introduced a new clause 49 to the listing agreements with stock exchange. This recommendation was a landmark in the history of Corporate Governance in India.

The Corporate Governance in banks can be traced to the RBI Standing Committee on International Financial Standards and Codes, which submitted its Report in 2002. 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 (Hemal, 2011) ^[34].

Corporate Governance and Financial Performance

Better Corporate Governance is supposed to lead to better financial performance by preventing the expropriation of controlling shareholders and ensuring better decision-making. In expectation of such an improvement, the firm's value may respond instantaneously to news indicating better Corporate Governance. However, quantitative evidence supporting the existence of a link between the quality of Corporate Governance and financial performance is relatively scanty (Imam and Malik 2007) ^[25]. Good governance means little expropriation of corporate resources by managers or controlling shareholders, which contributes to better allocation of resources and better financial performance. As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, which is another source of better financial performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and long lasting than those with firms with less effective governance.

Implications for the economy as a whole are also obvious. Economic growth will be more sustainable, because the economy is less vulnerable to a systemic risk. With better protection of investors at the firm level, the capital market will also be boosted and become more developed, which is essential for sustained economic growth. At the same time, good Corporate Governance is critical for building a just and corruption-free society. Poor Corporate Governance in big businesses is fertile soil for corruption and corruptive symbiosis between business and political circles. Less expropriation of minority shareholders and fewer corruptive

links between big businesses and political power may result in a more favourable business environment for smaller enterprises and more equitable income distribution (Magdi and Nadareh, 2002) ^[31]. According to a survey by McKinsey and Company (2002) in Malaysia, Adams and Mehran (2003) ^[2], cited that 78% of professional investors expressed that they were willing to pay a premium for a well-governed company. The average premium these investors were willing to pay generally ranged from 20% to 25%. Many scholars have attempted to investigate the relationship between good governance and financial performance in a more rigorous way.

Prior Studies on the Subject

The agency theory states that better Corporate Governance should lead to higher stock prices or better long-term financial performance, because when managers are better supervised, agency costs are decreased (Albanese *et al.*, 1997) ^[3]. However, as Gompers *et al.* (2001) ^[21] suggest, the evidence of a positive association between Corporate Governance and financial performance may be traced to the agency explanation. In connection with the relationship between Corporate Governance and financial performance, the most studied governance practices include board composition, board size and shareholder activities.

Board Composition: The composition of board members has been proposed to help reduce the agency problem (Weisbach, 1988) ^[22]. Empirical studies on the effect of board membership and structure on performance generally show results either mixed or opposite to what would be expected from the agency cost argument. While some studies find better performance for firms with boards of directors dominated by outsiders (Vafeas, 1999; Pfeffer and Salancik 2003) ^[42, 35], others find no such relationship in terms of accounting profits or firm's financial performance (Weisbach, 1988; Daily and Dalton, 1992; Rosenstein and Wyatt 1997 and Bhagat and Bolton 2008) ^[22, 12, 38, 6]. Daily and Dalton (1992) ^[12] provided analyses of 54 empirical studies of board composition and 31 empirical studies of board leadership structure and their relationships to firm's financial performance. They find little evidence of a relationship between board composition or leadership and firm financial performance. This is also evident in the study by Hermalin and Weisbach (1991) ^[23] and Bhagat and Black (2002) ^[5].

Board Size: A fairly clear negative relationship appears to exist between board size and financial performance (Yermack 1996) ^[44]. Eisenberg, Sundgren, and Wells (1998) ^[46], documented a similar pattern for a sample of small and midsize Finnish firms. Their study also revealed that board size and financial performance are negatively correlated. Lipton and Lorsch (1992); ^[45] Jensen (1993) ^[27] in their studies also confirmed that; limiting board size is believed to improve financial performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision-making of larger groups. A large board is likely to be less effective in substantive discussion of major issues and to suffer from free-rider problems among directors in their supervision of management (Hermalin and Weisbach 1991) ^[23]. Mak and Li (2001) ^[32] conducted an empirical analysis of firms listed on the Stock Exchange of Singapore. They stated that the sign and significance of the relationship between board size and financial performance, is sensitive to the estimation method.

Shareholder Activities: Baysinger and Butler (1985) ^[4] found little evidence that Corporate Governance resolutions initiated by shareholders lead to better financial performance. Smith and Watts (1992) ^[41], reported a positive performance effects for the Shareholders' activities of the California Public Employees' Retirement System. Huson *et al.* (2004) ^[24] showed that financial institutions could be fairly effective in pushing target companies to take steps to comply with their Corporate Governance proposals. They also find that any short-term valuation effects resulting from activities are dependent on the specific type of governance issue targeted. Gillan (2006) ^[20] find that shareholder proposals by individuals have small, positive announcement effects, while proposals by institutional investors have a small but significant negative effect on stock prices. Overall, the empirical literature on shareholders' activities in the United States seems to indicate that it has a negligible impact on corporate financial performance (Black *et al.*, 2003).

Conclusion

The special nature of banking institutions necessitates a broad view of Corporate Governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels. Due to special nature of the activities carried on by the banks, they face a lot of problems as far as the area of Corporate Governance is concerned. In the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. There exists a doubt as to what standard should be applied while enforcing Corporate Governance in banks. Central banks play an important role in this regard. The guidance paper issued by the Basel Committee is of paramount significance in enforcing Corporate Governance standards in various countries across the world. As far as best Corporate Governance practices for banks are concerned, they may include realization that the times are changing, establishing an effective, capable and reliable board of directors, establishing a corporate code of ethics by the banks for themselves, considering establishing an office of the chairman of the board, having an effective and operating audit committee, compensation committee and Corporate Governance committee in place, considering effective board compensation, disclosing the information and recognizing their duty to establish Corporate Governance procedures that will serve to enhance shareholder value.

Further, the complex nature of banking business justifies the Corporate Governance mechanism as an important part for the vigilance of its regulations. Literature suggests that banks with effective Corporate Governance mechanisms have better financial performance.

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