Corporate Governance in Banking System

An Empirical Investigation

The paper examines the issue of corporate governance in the Indian banking system. Using data on banking systems for the period 1996-2003, the findings reveal that CEOs of poorly performing banks are likely to face higher turnover than CEOs of well performing ones.

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I
Introduction

Few public policy issues have moved from the periphery to the centre as quickly and decisively as corporate governance. Virtually every major industrialised economy and major international organisation has made efforts in recent years to refine their views on how large industrial corporations should be organised and governed. Academics in both law and economics have also intensely focused on corporate governance [La Porta et al1998]. Despite the growing literature in the field [see Shleifer and Vishny 1997, for a survey], very little attention has been focused on the issue of the corporate governance, especially in banking organisations. As Shleifer and Vishny (1997) point out in their survey, there has been very little research done on corporate governance outside the United States, apart from a few developed countries, such as Japan and Germany. As has been observed, "despite the general focus on this topic, very little attention has been paid to the corporate governance of banks. This is particularly strange in light of the fact that a significant amount of attention has been paid to the role that banks themselves play in the governance of other sorts of firms" [Macey and O'Hara 2003].

The corporate governance of banks in developing economies is important for several reasons. First, banks have an overwhelmingly dominant position in developing economy financial systems, and are extremely important engines of economic growth [King and Levine 1993 a,b; Levine 1997]. Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms. Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings. Fourth, many developing economies have recently liberalised their banking systems through privatisation/disinvestments and reducing the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

As Caprio and Levine (2002) point out, two inter-related features of financial intermediaries affect corporate governance. First, banks are more opaque, which intensifies the agency problem. Due to greater information asymmetries between insiders and outside investors, in banking, it is (a) more difficult for equity and debt holders to monitor managers and use incentive contracts; and, (b) easier for managers and large investors to exploit the private benefits of control, rather than maximise value. Second, banks are heavily regulated and this frequently impedes natural corporate governance mechanisms. For instance, (a) deposit insurance reduces monitoring by insured depositors, reduces the desirability of banks to raise capital from large, uninsured creditors with incentives to monitor and increases incentives for shifting bank assets to more risky investments; and (b) regulatory restrictions on the concentration of ownership interfere with one of the main mechanisms for exerting corporate governance around the world: concentrated ownership.

This paper examines the issue of corporate governance in banking organisations in the Indian context. The paper seeks to explore the link between CEO turnover and bank performance. The rest of the paper proceeds as follows. Section I provides an overview of the relevant literature. Section II describes the econometric methodology. The data pertaining to the study is described in Section III. A discussion of the results is contained in the penultimate section, while the final section gathers the concluding remarks.

II
Literature Overview

A few studies have examined corporate governance in emerging markets, although none has estimated the link between CEO turnover and corporate performance, that is the focus of this paper. Researchers have studied the implications of the concentrated ownership that is common in many emerging and developed markets. La Porta et al (1999) study corporate governance patterns in 27 countries and conclude that "the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders".

More recently, the intellectual debate on corporate governance has come to focus on two different issues. The first concerns whether corporate governance should focus exclusively on protecting the interests of equity claimants, on whether corporate governance should expand its role to deal with the problem of the other group: the 'stakeholders' or non-shareholder constituencies. The second issue of importance to corporate governance scholars begins with the assumption that corporate governance concerns itself exclusively with the challenge of protecting equity claimants and attempts to specify ways in which the corporation can better safeguard those interests [BCBS 1999].

Some recent studies have attempted to explore the issue of corporate governance in banking organisations. Boubakri et al (2003) examine the corporate governance features of newly privatised firms in Asia and documents how their ownership structure evolves after privatisation. The results suggest that, on the one hand, privatisation leads to a significant improvement in profitability, while, on the other hand, it creates value for shareholders. Joh (2003) presents evidence on corporate governance and firm profitability from Korea before the economic

crisis and finds that the weak corporate governance system offered few obstacles against controlling shareholders expropriation of minority shareholders. In fact, weak corporate governance systems allowed poorly managed firms to stay in business and resulted in inefficiency of resource allocation, despite low profitability over the years. Anderson and Campbell (2003) investigate corporate governance activity at Japanese banks. The results indicate that there does not exist any relation between bank performance and non-routine turnover of bank presidents, in the pre-crisis (1985-90) period, although there is an observed significant relationship between turnover and performance in the post-crisis (1991-96) period.

The role and the need of good corporate governance in India have been reiterated in several forums [Verghese 2002]. Reddy (1998) had recommended that the positions of chairman and managing director in public enterprises[1] would be needed to be vested in one person as against the popular view for the private sector. This is in order to protect the interests of the organisation. The major challenge in progressing to good corporate governance is to build essential knowledge on relevant laws, duties and responsibilities, financial analysis, strategy, business ethics and effective decision-making [Reddy 2001]. However, Kohli (2003) stressed that corporate governance has to be perceived and understood in a much broader spectrum, encompassing all players involved in the business, instead of restricting it only to board and executive management. It is believed that a company having better corporate governance is quoted at a premium in the bourses than those with weak corporate governance practices.

As regards the issue of corporate governance in banking organisation, Jalan (2000) has examined the issue of corporate governance in public versus private banks and thereafter. Reddy (2002) has discussed the governance challenges in public sector banking (Table 1). To quote from Reddy (2002):

> Corporate governance in PSBs is important, not only because PSBs happen to dominate the banking industry, but also because, they are unlikely to exit from banking business though they may get transformed. To the extent there is public ownership of PSBs, the multiple objectives of the government as owner and the complex principal-agent relationships cannot be wished away. PSBs cannot be expected to blindly mimic private corporate banks in governance though general principles are equally valid. Complications arise when there is a widespread feeling of uncertainty of the ownership and public ownership is treated as a transitional phenomenon. The anticipation or threat of change in ownership has also some impact on governance, since expected change is not merely of owner but the very nature of owner. Mixed ownership where government has controlling interest is an institutional structure that poses issues of significant difference between one set of owners who look for commercial return and another who seeks something more and different, to justify ownership. Furthermore, the expectations, the reputational risks and the implied even if not exercised authority in respect of the part-ownership of government in the governance of such PSBs should be recognised. In brief, the issue of corporate governance in PSBs is important and also complex.

III Econometric Methodology

Since the focus of the paper is on evaluating corporate governance in an emerging country banking market, the focus is on corporate governance outcomes rather than on corporate governance mechanisms. Specifically, we examine the relationship between turnover of bank chairmen (who we term as chief executive officer or CEO) and bank performance. Such an approach, especially in the context of developed country (US, Germany and Japan) corporates, had been adopted by Kaplan (1997) and has been, more recently, employed by Gibson (2003). While examining such a relationship may be a necessary feature of a corporate governance system, it is by no means a sufficient condition. Looking at the relationship between CEO turnover and performance tests whether corporate governance is effective or not; on its own, it fails to prove how to make it effective.

We estimate a relationship between CEO turnover and corporate performance of the following form:

$$\textit{CEO turnover} = f\,(\textit{firm performance, control variables}) \quad (1)$$

In particular, we test whether there exists a negative relationship between CEO turnover and firm performance. Since CEO turnover is a binary variable, we choose to estimate the following logit regression:

$$\Pr ob\{\textit{CEO turnover}\} = f\,(\beta\,\textit{firm performance}, +\gamma' Z) \quad (2)$$

where β captures the relationship of interest, γ is a k x 1 vector of coefficients, Z is a k x 1 vector of control variables and f (.) is the logistic function f(a)=[exp(a)/1+exp(a)]. The model is estimated using bank-specific fixed effects.

IV Measurement and Data

The estimation procedure comprises of two sets of results. First, we estimate the relationship between CEO turnover and performance in public sector banking system and in a subsequent stage, we estimate the relationship for all bank groups (public/old and new private/foreign).

For the public sector banks, the analysis covers the period 1996 through 2003. The data on names of CEO of individual banks has been culled out from the audited annual reports of banks. In several public sector banks, the CEO is better known as the chairman or the chairman-cum-managing director. In the State Bank Group, since the chairman of State Bank of India is necessarily the chairman of its associate banks, the top post in that organisation, apart from the chairman, is that of the managing director, whom we identify as the CEO in that bank. There are several data constraints we need to reckon with in this case. First, not much is known about the CEO apart from his/her name. There is also paucity of consistent data on characteristics that will affect the probability of CEO turnover such as the age and tenure at the firm. It is plausible to argue that these CEO characteristics are uncorrelated with firm performance. In that case, their absence will worsen the fit of the regression models, making it harder

Table 1: Studies on Corporate Governance in Banking

Author/Year	Country/ Period	Issue
Jalan (2000)	India	Corporate governance in public versus private banks
Reddy (2001)	India	Features of corporate governance in Indian banking
Anderson and Campbell (2003)	Japanese banks 1985-96	Link between corporate governance and bank president turnover
Adams and Mehran (2003)	US banks1986-1999	How corporate governance differs in bank holding companies
Macey and O'Hara (2003)	General	Issues related to corporate governance in banking

to find any effect of firm performance on CEO turnover, but will not bias the coefficient on firm performance. Second, we do not also know whether in case of departure of the CEO, it was voluntary or otherwise. Obviously, the link between forced CEO turnover and firm performance is what is relevant to the effectiveness of a corporate governance system, the topic addressed by the paper. To control for this possibility, we introduce year dummies: the identifying assumption being firm performance affected the probability of forced turnover, while year dummies affected the probability of unforced turnover. Third, in several cases, the CEO of one bank might have gone on to later become the CEO of another bank. Our conjecture is that the measures of firm performance included would, along with the year dummies, pick up some of these effects.

We use return on assets (RoA), calculated as net profit to total asset, as the measure of firm performance as it is the most encompassing measure. To account for the fact whether previous year's performance affects CEO turnover, we also use the change in RoA calculated as RoA minus the previous year's RoA [Anderson and Campbell, 2003]. As per our hypothesis, the coefficient on RoA should be negatively related with CEO turnover. We also alternately employ operating profits (EARN) as a measure of performance.

We employ several controls to account for bank-specific features. First, we employ natural logarithm of total assets (SIZE) to ascertain the fact whether turnover is higher in bigger banks or otherwise. Second, we employ the capital adequacy ratio (CRAR) to examine whether better-capitalised banks exhibit lower CEO turnover. The 'gamble for resurrection' strategy would suggest that inadequately capitalised banks would tend to have a riskier loan portfolio in order to shore up their capital levels, which is likely to lead to lower profitability and consequently, higher turnover. The non-performing loan ratio (NPL), defined as the ratio of gross non-performing loans to gross advances is also included as an explanatory variable to capture the efficacy of credit risk management at the bank. To the extent that the bank had poor credit risk management techniques, this would reflect adversely on CEO performance and possibly result in higher turnover. Finally, to control for the economic environment, we employ the real GDP growth rate (GDPGR), but do not conjecture any sign on this variable and instead, leave the same to be econometrically determined. Finally, as mentioned earlier, year dummies have been included to capture any time-specific effects.

V
Results and Discussion

Summary statistics for the variables are presented in Table 2. It is observed that, among bank-specific variables, there exists a negative correlation between the dependent variable and performance (as measured by RoA), suggesting CEO turnover is lower in banks with better performance. It is also observed that bigger banks as well as those with higher non-performing loans have lower CEO turnover.

The result of the empirical exercise is provided in Table 3. Two sets of results are presented: the first with RoA as a measure of bank performance and the other, with operating profits as a measure of bank performance.

Three salient features of the results deserve a mention. Irrespective of whether which measure of bank performance is considered, lagged value of the performance measure has a significant influence on CEO turnover. In other words, bank performance does impinge upon CEO turnover. Second, SIZE is observed to negatively and significantly impact CEO turnover, suggesting that bigger banks tend to have lower probability of rotation of CEOs. It might well be possible that, only with the passage of time, CEOs tend to become fully conversant with the functioning of bigger banks, this would suggest that CEOs in bigger banks tend to get a longer tenure to cover for the lock-in period to become fully conversant with the bank's operations. Third, capital is observed to have a significant influence on CEO turnover: inadequate capital position being associated with higher CEO turnover. Better-capitalised banks are perceived as safer; lower capital, as a consequence, reflects inadequately on CEO performance, thereby possibly engendering higher turnover.

An interesting question of importance is whether performance of CEO is, in any way, impacted by the fact whether a bank is listed or otherwise. Towards this end, we construct a variable (LISTING), which assumes value 1 for the year (and all subsequent years) in which a bank has made an equity offering, and zero, otherwise. The revised set of estimation results, with RoA as measure of bank performance, is presented in Table 4.

While most variables which were significant earlier retain their significance at conventional levels and with the same signs as earlier, it is observed that when RoA is employed as a measure of performance, LISTING appears with a negative sign and turns out to be at the border of significance. Since listing a bank is associated with strengthening the bank's internal control mechanisms and its corporate governance characteristics, this would suggest that having a public sector bank listed on the stock exchange tends to be associated with lower CEO turnover.

Having obtained these results, we proceed to examine how the results differ across bank groups. In order to obtain a balanced panel dataset, the subsequent analysis encompasses 62 banks (27 public sector banks, 10 foreign banks, eight new private banks and 17 old private banks). The revised set of estimation results is presented in Table 5.

Several features of the results deserve a mention. First, most variables which were significant in the earlier case retain their significance in this case as well. Thus, lagged performance measures are significant in almost all cases, except foreign banks for whom contemporaneous performance measure is found to have a significant impact on CEO turnover. Second, for old

Table 2: Correlation Matrix of the Variables

Variable	DEPVAR	RoA	SIZE	CRAR	GNPA	GDPGR
DEPVAR	1.000					
RoA	-0.084	1.000				
SIZE	-0.024	0.145	1.000			
CRAR	-0.106	-0.722	-0.138	1.000		
NPL	0.096	0.789	0.204	-0.703	1.000	
GDPGR	-0.070	-0.092	-0.224	0.206	-0.192	1.000

DEPVAR is the dependent variable.

Table 3: CEO Turnover and Performance – Logistic Model

Variable	Coefficient (p-value)	Coefficient (p-value)
Constant	3.995 (0.35)	2.881 (0.49)
Performance Measure		
RoA	0.017 (0.77)	—
Lagged RoA	-0.064 (0.05)	—
EARN	—	-0.0002 (0.15)
Lagged EARN	—	-0.099 (0.06)
Control Variables		
SIZE	-0.226 (0.06)	-0.089 (0.07)
NPL	0.006 (0.52)	0.002 (0.86)
CRAR	-0.005 (0.02)	-0.006 (0.03)
GDPGR	-0.169 (0.31)	-0.166 (0.32)
Year dummies	Included	Included

private banks, non-performing loans seem to influence CEO turnover. Since the credit risk management skills in this bank group is, more often than not, relatively less adequate than the new private/public or even foreign counterparts, it seems that the asset quality of these banks is important in determining CEO turnover. Third, while capital adequacy matters for public sector and old private banks, it seems to have limited influence in case of new private and foreign bank groups. Since foreign banks have the backing of their host country parents and new private banks have to perforce satisfy stipulated capital adequacy requirements since their inception, this variable does not play an important role in influencing CEO turnover. Finally, SIZE matters only in case of public sector banks, possibly implying that CEO turnover is sensitive to the 'too-big-to-fail' effect. All in all, the results can be stated to be relatively robust and suggest that bank performance has a bearing on CEO turnover.

VI
Concluding Remarks

The paper has studied corporate governance in emerging markets by examining Indian banking systems in India. In a sample of 27 public sector banks in India, CEOs of poorly performing banks are likely to face higher turnover than CEOs of well-performing ones. Along this dimension, corporate governance is effective. Measures of performance based on return on assets have the strongest association with CEO turnover, while listed firms have a weaker association. Similar results are obtained when the sample is extended to encompass the entire banking system, include a sample of foreign/new private and old private banks.

It is important to keep in mind that these findings do not imply that corporate governance in Indian banks is perfect. Indeed, the results presented may contain seeds of concern for the future of emerging market corporate governance. The importance of earning-based measures of corporate governance is broadly in consonance with what Kaplan (1997) observed for Japanese banks. As emerging markets like India continue to grow and become more integrated with the global economy, more research will be needed to examine if their corporate governance systems also mature. EPW

Table 4: CEO Turnover and Performance – Logistic Model with Listing as Additional Explanatory Variable

Variable	Coefficient (p-value)
Constant	3.669 (0.39)
Performance Measure	
RoA	0.011 (0.84)
Lagged RoA	-0.063 (0.05)
Op PROF	—
Lagged (Op PROF)	—
Control Variables	
SIZE	-0.185 (0.06)
NPL	0.006 (0.16)
CRAR	-0.003 (0.03)
GDPGR	-0.174 (0.31)
LISTING	-0.134 (0.10)
Year dummies	Included

Figures in brackets indicate p-values.

Table 5: CEO Turnover and Performance – Logistic Model Bank Groupwise Results

Variable	Public Sector Banks	Old Private Banks	New Private Banks	Foreign Banks
Constant	2.616 (0.26)	2.235 (0.42)	—	—
Performance Measure				
RoA	0.016 (0.84)	0.021 (0.63)	0.014 (0.66)	-0.019 (0.03)
Lagged RoA	-0.031 (0.04)	-0.019 (0.08)	-0.046 (0.06)	-0.011 (0.11)
Control Variables				
SIZE	-0.015 (0.06)	-0.014 (0.11)	-0.018 (0.14)	-0.009 (0.12)
GNPA	0.006 (0.14)	0.002 (0.10)	0.011 (0.16)	0.013 (0.11)
CRAR	-0.006 (0.03)	-0.005 (0.05)	-0.010 (0.14)	0.012 (0.15)
GDPGR	-0.174 (0.31)	-0.169 (0.26)	-0.191 (0.33)	-0.147 (0.29)
Year dummies	Included	Included	Included	Included

Figures in brackets indicate p-values.

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Note

[The views expressed in the paper are the personal views of the authors.]

1 Public enterprises comprise listed and unlisted government enterprises, the central and state level corporations, public sector, banks, insurance and financial institutions, cooperatives and department undertakings.