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Corporate Governance In Indian Financial System: An Empirical Study

Abstract

Corporate governance is a topic of considerable interest to a large and expanding cross-section of the community. Governance of the banking sector has received particular attention due to the sector's enormous influence on developing economies, especially where stock markets are underdeveloped like India and the financial system design is bank-dominated. This paper empirically studied the difference between the level of corporate governance in banking and non-banking financial institutions and revealed that the level of corporate governance is high in non-banking financial institutions. While analyzing underlying key factors of corporate governance, management conscientiousness and corporate policy were emerged as two important factors. The study concluded that there is a significant difference between banking and non-banking financial institutions regarding corporate governance policy, international accounting standard and auditing system, transparency, training of corporate governance and internal control while labor union indicated no such difference.

INTRODUCTION

With recent growth, India has experienced an economic transformation since the liberalization process began in the early 1990's. In the last few years, the Indian financial system has been witnessing an exciting era of transformation, which consists of financial markets, financial intermediation and financial instruments or financial products. These reforms have paved the way for integration among various segments of the financial market and they focus on (a) elimination of segmentation across various markets in order to facilitate transmission of impulses across markets, (b) easing the liquidity management process and (c) making resource allocation more efficient across the economy. The banking sector as a part of financial system has seen major changes with deregulation of interest rates and the emergence of strong domestic private players as well as foreign banks.

Since banks are important players in the Indian financial system, special focus on the Corporate Governance in the banking sector becomes crucial. Banking supervision cannot function as well if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organisation. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Thus the extent to which banks have complete implications, Corporate Governance in the banks is of critical importance.

The OECD paper defines corporate governance as involving "a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."

As banks and financial institutions are critical components of any economy. They provide finance to commercial enterprises, basic financial services to a broad segment of the population, access to payments systems and expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually a regulated industry and that banks have access to government safety nets. Therefore it is of crucial importance that banks have strong corporate governance.

In this field Basel Committee published a paper for banking organisations in September 1999 and for banking organisations in September 1999 and suggested that it is the responsibility of the banking supervisors to ensure that there is effective corporate governance in the banking industry. The committee underline the need for banks to set strategies for their operations and establish accountability for executing these strategies. In addition, transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that, so it gives the market participants sufficient information with which they can judge the management of a bank. It also highlighted the need for having appropriate accountability, checks and balances within each bank to ensure sound corporate governance, which in turn would lead to effective and more meaningful supervision.

There were certain deficiencies Basel I norm and Basel committee came out with modified approach in June 2004. The final version of the Accord titled "International Convergence of Capital Measurement and Capital Standards-A Revised Framework" was released by BIS. This is popularly known as New Basel Accord or Basel II which seeks to rectify most of the defects of Basel

The objectives of Basel II are the following:

1. To promote adequate capitalisation of banks.
2. To ensure better risk management and.
3. To strengthen the stability of banking system.

Therefore, from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

- Set corporate objectives (including generating economic returns to owners)
- Run the day-to-day operations of the business
- Consider the interest of recognised stakeholders
- Align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations
- Protect the interests of depositors

REVIEW OF LITERATURE

Das et al (2004) examined the issue of corporate governance in the Indian banking system and found that CEOs of poorly performing banks are likely to face higher turnover than CEOs of well performing ones. Chakrabarti (2005) posited that high-profile corporate governance failures in developed countries have brought the subject to media attention and it was an important issue for developing countries sine it is central to financial and economic development. The

research established that financial development is largely dependent on investor protection in a country. He posited that India has one of the best corporate governance laws but poor implementation together with socialistic policies which has affected corporate governance. Adams et al (2003) used a sample of bank holding companies and manufacturing firms to analyze a range of corporate governance variables, such as board size, percentage of outside directors, and number of board meetings. They concluded that these observed differences may be due to variations in the investment opportunities of the firms in the two industries and the regulatory environment in the banking industry. Arun et al (2004) posited that a broader view of corporate governance should be applied to the banking sector, considering the special nature of this sector. They pointed out that corporate governance of banks in developing economies was much more influenced by political decisions than other corporate governance issues. Levine (2004) examined the corporate governance of banks and found that the weak governance of bank reverberates throughout the economy with negative ramifications for economic development. Crespi et al (2002) contended that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value-maximizing policies. They observed that these methods may be external to the firm, as the market for corporate control or the level of competition in the product and labor markets and that there are also internal mechanisms such as a disciplinary intervention by shareholders or intervention from the board of directors. Bathala et al (2007) studied the difference between corporate governance structures of banking and non banking firms. The evidence sheds light on the implication of the regulatory oversight and firm size for corporate governance structure in firm. Their findings showed a significant difference between banks and non-banks with regards to the corporate governance structure. Caprio et al (2004) focused on laws, bank supervisory strategies, and bank regulations that improve the governance and performance of banks. Their results supported the view that the expropriation of minority shareholders is an important issue on an international level and that laws can control this expropriation. They further advocated that an important mechanism in the governance of banks was the concentration of cash flow rights.

Felton (2004) surveyed corporate directors and institutional investors and revealed that if directors do not show leadership on corporate governance reforms, investors will. Boards that embrace reform may well reap a trust premium, while those that continue to ignore the call for change will be serving neither management nor shareholders well. Berth et al (2001) demonstrate that regulation and supervisory systems that foster more accurate information disclosure empower private investor's legal rights, and does not offer very generous deposit insurance substantially boost banking system performance and stability. Wang et al (2003) examined the relationship between corporate governance and innovation in the Chinese banking sector. Drawing on interviews with senior managers and employees in state-owned, joint-holding and foreign banks, they examined the nature of the challenges faced by different types of firms in the context of reform and globalisation. Firms with different ownership structures respond to the challenges in ways that reflect different resource allocation and commitment mechanisms. Denis et al (2003) divided the study into two separate generations of research. The first generation is based on U.S. research of past corporate governance systems, with a focus on country studies. They found that there were important differences in corporate governance systems around the world. The second generation or research examines countries as a cohesive framework and found that a country's legal system had a significant influence on various aspects of corporate governance, especially the extent to which it protects investor rights. Lei et al (2004) studied whether better corporate governance leads to higher valuation through lower expected rate of return. They used a time-

varying scorecard developed by S&P's to assess the corporate governance of UK listed companies and revealed an interesting relationship between governance and performance. They found that an investment strategy that buys firms with greatest improvement in governance and sells firms with largest deterioration in returns over the sample period.

Doidge et al (2004) studied the importance of particular country characteristics - such as legal protections for minority investors, and the level of economic and financial development - in creating and improving national measures for governance and transparency. The study revealed that at a given level of country investor protection, better governance mechanisms are more likely to be accepted at the firm level as a country's financial and economic development improves. Nenova (2001) measured the value of corporate control in companies across eighteen countries. The author defines the value of corporate control as the value that dominant vote-holders expropriate from a controlled company to the detriment of other shareholders. This value was found to range from 0% in Denmark to 50% of the firm market value in Mexico. A country's legal environment was the main explanatory factor for the divergence between countries. In particular, the strictness of law enforcement, takeover regulations, and Corporate Charter provisions where key determinants in determining the concentration of power in the hands of the controlling shareholder. Durnev et al (2004) researched that firms scoring higher in governance and transparency rankings are more greatly valued in the stock market. The study found that, that although firms are valued higher in stronger legal environments, this relationship becomes insignificant when scores on the quality of governance and disclosure are taken into account. These results suggest that economic policies play a crucial role in leading firms toward good governance practices. Roe (2003) argued that the government's effect on firms and the ways in which firms react to certain political decisions can influence what types of ownership structures and other corporate governance arrangements survive or fail. These results strongly suggest that the corporate governance and ownership characteristics are linked, directly or indirectly, to basic political configurations.

Berglof et al (2003) discussed the approaches and challenges faced in implementing effective corporate governance tools in areas, where private enforcement mechanisms are the most efficient but require public laws to function. Ashbaugh, Collins and LaFond (2004) provided insights into the characteristics of governance that are likely to affect a company's cost-of-debt financing. They also explain why some firms continue to operate with weaker governance even though it may result in lower credit ratings. Agarwal and Knoeber (2001) suggested that the need for political clout and relations with regulators may be an important factor for firms in such industries as banking and they may find it beneficial to have larger board.

OBJECTIVES OF STUDY

- To develop and standardized a measure for analyzing corporate governance level in banking and non-banking financial institutions.
- To analyze the underlying factors of corporate governance.
- To compare the differences between the corporate governance of banking and non-banking financial institutions.
- To open new vistas for further research.

RESEARCH METHODOLOGY

The study is descriptive in nature. Total population was banking and non-banking institutions in India. Total sample size was 30 corporations which include 15 banking institutions and 15 non-banking institutions and the individual institutions were the sampling element. The non-banking financial institutions include mutual fund, insurance and investment

companies. The purposive (non-probability) sampling technique was used to complete the study. A self-designed questionnaire was used for data collection which was made up of two parts. The first part consisted of questions which could be answered in yes or no form and the next part consisted of questions which could be answered on the likert-type scale of 1 to 5. The tools used for data analysis where item to total correlation which was applied to check the consistency of various items used in the questionnaire. For testing the reliability, Cronbach alpha was applied to the items and validity of the questionnaire was checked using face validity method which was found to be high. Finally in order to find out the factors affecting corporate governance in banking and non-bankin financial institutions, factor analysis was applied using SPSS 13.0 software. After that Chi-test was applied to find out the difference banks and non-banking financial institutions and finally T-test was applied to find out the difference between two samples.

HYPOTHESIS

The major hypothesis of the study was:

H_0 : There is no difference between the level of corporate governance in banking and non-banking financial institutions.

H_{o1} : There is no difference between banking and non-banking financial institutions towards the existence of written corporate governance manual or policy.

H_{o2} : There is no difference between banking and non-banking financial institutions towards the existence of internationally recognized accounting and auditing system.

H_{o3} : There is no difference between banking and non-banking financial institutions towards the existence of sufficient number of independent directors.

H_{o4} : There is no difference between banking and non-banking financial institutions towards the existence of an audit committee.

H_{o5} : There is no difference between banking and non-banking financial institutions towards the existence of transparent and clear structure of responsibility.

H_{o6} : There is no difference between banking and non-banking financial institutions towards the existence of separate Fraud and Corruption Policy and Whistle blowing Policy.

H_{o7} : There is no difference between banking and non-banking financial institutions towards the existence of corporate wide training that teaches every employee the principle of corporate governance and internal control.

H_{o8} : There is no difference between banking and non-banking financial institutions towards the existence of labor union.

RESULTS AND DISCUSSIONS

The Chi-square was applied in the first part of the questionnaire were the items were answered in yes or no form-

Chi-square test: Chi-square test was applied to find out the significant difference between the level of corporate governance in banking and non-banking financial institutions. Standard value is 3.84 at 5% level of significance and degree of freedom is one.

Calculated value< 3.84, Ho is accepted.

The result of the chi-test as shown in table 4 depict that the value of chi-square in case of H_{o1}, H_{o2}, H_{o3}, H_{o4}, H_{o5}, H_{o6}, H_{o7} was more than the standard value of 3.84 at 5% level of significance. Therefore the null hypotheses in these cases were not accepted. Thus there seems to be significant difference in written corporate governance manual or policy, internationally recognized accounting and auditing system, number of independent directors, audit committee, transparent and clear structure of responsibility fraud and corruption policy and whistle blowing policy, training of corporate governance and internal control. The chi-value in case Ho8 was less than the standard value so the alternate hypothesis was not accepted. Thus it was found that labor union showed no significant difference in both the sectors. Therefore we can suggest that labor unions have negligible effect on corporate governance and they are formed irrespective of the type of organization.

The Results Based On Part B of the Questionnaire.

Consistency : The consistency of all the items in the questionnaires was checked through item-to-total correlation. Correlation of every item with total was measured and the computed value was compared with cut off value or standard value of 0.347343 as per table-1. The computed value was found high and so none of the item was dropped.

Reliability: For checking the reliability of the questionnaire, Cronbach Alpha was calculated. The reliability value was found to be 0.878 (See table 2). The reliability of more than 0.7 was considered good. Thus the reliability of the questionnaire was found high.

Factor Analysis: Factor Analysis using principal component Varimax rotation was applied on the raw scores of 8 items to find out the factors that contribute towards Corporate Governance in banking and non-banking financial institutions. These factors are briefly introduced below as per table 3:

1. **Management Conscientiousness:** This factor has emerged as the first important determinant of the research with a total variance of 4.329. Major element consisting this factor include Adequate number of Directors (.848), Fraud policy (.846), Audit committee (.827) and Training program (.799) During this research it was found that management conscientiousness plays an important role in the corporate governance of the banking and non banking financial companies. Crespi et al (2002) contend that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value-maximizing policies.

2. **Corporate Policy :** This factor has emerged as the second most important determinant of research with a total variance of 1.171. Major items consist this factor are influence of Written corporate system (0.753), Transparency (.707) and Labor union (0.645). It was found that during this research corporate policy plays a vital role. Durnev et al (2004) researched that firms scoring higher in governance and transparency rankings are more greatly valued in the stock market. These results suggest that economic policies play a crucial role in leading firms toward good governance practices.

T-test was applied to see whether there was a significant difference between the corporate governance level in banking and non banking financial institutions. If value of T is less than standard value, 2.048 at 5% level of significance, the null hypothesis is accepted. The computations are presented in table 5. The computed standard error is shown in table 6

Ho : There is no difference between the level of corporate governance in banking and non banking industry.

The T-test value (2.180822368) as shown in table 6 is not accepted because is more than the tabulated value (2.048) at 5% level of significance. Therefore, there is a significant difference between the level of corporate governance in banking and non-banking financial institutions. Thus the null hypothesis is not accepted. In general, it can be observed that the non-banking financial institutions are better in following the corporate

governance principles. The results were same as obtained by Bathala et al (2007) who studied the difference between corporate governance structures of banking and non-banking firms. The evidence sheds light on the implication of the regulatory oversight and firm size for corporate governance structure in firm. Their findings show a significant difference between banks and non-banks with regards to the corporate governance structure.

CONCLUSION

Corporate Governance incorporates all the principles and regulations relating to the management and control of a company. Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationship among the many players involved (the stakeholders) and the goals for which the corporation is governed. The study reveals that there is an overall significant difference in the level of corporate governance between banking and non-banking financial institutions. This study has given a fruitful result in developing a standard questionnaire regarding the corporate governance in banking and non-banking financial institutions.

The study contributed the factors like management conscientiousness and corporate policy. While the results of Chi square and T-test found that there was significant difference in corporate governance between banking and non-banking financial institutions. It has also been found that the level of corporate governance is significantly higher in non-banking financial institutions.

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ANNEXURES : QUESTIONNAIRE

Part-A

1. Does the company have a written corporate governance policy or manual?

   Yes ( ) No ( )

2. An internationally recognized accounting and auditing system is in place?

   Yes ( ) No ( )

3. Does the board have a sufficient number of independent directors?

   Yes ( ) No ( )

4. Does the board have an audit committee?

   Yes ( ) No ( )

5. Is there a transparent and clear structure of responsibility, which differentiates between what, the Board can do, and what managers and employees can do?

   Yes ( ) No ( )

6. Does the organization have a separate Fraud and Corruption Policy and Whistle blowing Policy?

   Yes ( ) No ( )

7. Does the corporation have a corporate wide training program that teaches every employee the principles of corporate governance and internal control?

   Yes ( ) No ( )

8. Does the firm have a labour union?

   Yes ( ) No ( )

Part-B

Please give your responses on the scale of 1 to5 where 1 indicates minimum and 5 indicate maximum.

1. How easily Corporate Governance policy or manual available to the regulators and the general public?

   1 2 3 4 5

2. How good is the performance evaluation system of the corporation?

   1 2 3 4 5

3. Up to what extent does the annual report discuss the company's risk management system and its corporate governance practices?

   1 2 3 4 5

4. How regularly meetings of the board and subcommittees held?

   1 2 3 4 5

5. Up to what extent shareholders are given regular and adequate disclosure reports?

   1 2 3 4 5

6. Is adequate time given for asking questions and placing issues at the shareholders' meeting?

   1 2 3 4 5

7. How far the members of the board understand their responsibilities?

   1 2 3 4 5

8. How good is the code of ethics for the entire corporation?

   1 2 3 4 5

Name of Organization ____________________

Table 1: Showing Items to Total Correlation

Item	Correlation Value	Consistency/ Inconsistency	Dropped/ Accepted
Written corporate policy	0.57471	Consistent	Accepted
International accounting system	0.570589	Consistent	Accepted
Adequate number of directors	0.899158	Consistent	Accepted
Audit committee	0.829646	Consistent	Accepted
Transparency	0.737628	Consistent	Accepted
Fraud policy	0.755726	Consistent	Accepted
Training program	0.723517	Consistent	Accepted
Labor union	0.731755	Consistent	Accepted

Table 2 : Reliability Statistics

Cronbach's Alpha	No. of Items
0.878	8

Table 3: Showing Factors of the Study

Factor No.	Eigen Value		Variance of Convergence	Loading
	Total Variance	Percent of Variance		
Management Conscientiousness	4.329	54.112	3 (Adequate number of Directors) 6 (Fraud policy) 4 (Audit committee) 7 (Training program)	0.848 0.846 0.827 0.799
Corporate policy	1.171	14.635	1 (Written corporate policy) 2 (International accounting system) 5 (Transparency) 8 (Labor union)	0.791 0.753 0.707 0.645

Table 4: Comparison of the Items of Corporate Governance

Item	Assumption	Chi-square value	Difference
Written corporate governance manual or policy	$H_{01}, x_1 = x_2$ x_1 = Banking institutes, x_2 = Non-banking financial institutes	181.07	Significant
Internationally recognized accounting and auditing system	$H_{02}, x_1 = x_2$	69.8076	Significant
Number of independent directors	$H_{03}, x_1 = x_2$	21.0551	Significant
Audit committee	$H_{04}, x_1 = x_2$	87.1851	Significant
Transparent and clear structure of responsibility	$H_{05}, x_1 = x_2$	22.44712	Significant
Fraud and Corruption Policy and Whistle blowing Policy	$H_{06}, x_1 = x_2$	7.9	Significant
Training of corporate governance and internal control	$H_{07}, x_1 = x_2$	30.08323	Significant
Labor union	$H_{08}, x_1 = x_2$	2.39817	Insignificant

Table 5: Values of Mean and Standard Deviation of Banking and Non-Banking Financial Institutions

Type	Mean	S.D.	Sample Size
Bank	26.7333	7.601378	15
Non Bank Financial Instituions	31.73333333	4.589843861	15

Table 6: Showing T-Value

SE	6.278853399
T	82.180822368

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