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Bank Ownership, Board Characteristics and Performance: Evidence from Commercial Banks in India

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The role of the board of directors in the governance of financial institutions has come under increasing scrutiny from both policy makers and researchers in the aftermath of the global financial crisis of 2008. Following the crisis, in October 2010 the Basel Committee (Basel, 2010) issued a set of principles for enhancing corporate governance practices in banking organizations and highlighted the importance of the board of directors, the qualifications and composition of the board, the importance of monitoring risks at the firm level on an ongoing basis, the board's oversight on executive compensation and the board and senior management's understanding of the bank's operational structure and risks.[22] Other international efforts at promoting better governance of banks by the board of directors came through the OECD (OECD, 2006) and the Walker Review (Walker, 2009).

Notwithstanding the plethora of recommendations on the optimal role of the board of directors in governing banks, there is relatively scant empirical evidence on how banks are actually governed. Further, of the existing empirical evidence on board governance in banks pertain to privately owned banks in developed countries, particularly the US, and very little is known on the effectiveness of the board of directors in the governance of banks in countries dominated by state-owned banks, and how this compares vis-à-vis private banks.

In view of the above, this paper aimed to provide evidence on the role played by

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22 http://www.bis.org/publ/bcbs176.htm
Even before the crisis, the importance of sound governance in banking and other financial institutions was underscored by the Basel Committee on Banking Supervision in 1999 which published guidelines to encourage banks to adopt sound corporate governance practices.

the board of directors on bank performance with a study of commercial banks in India. India is the country with the second largest number of commercial banks after the US. However, unlike the US which comprises of only private sector banks, the Indian banking system comprises of both state-owned banks, referred to as public sector banks, and privately-owned banks, referred to as private sector banks, thereby providing a natural setting to analyze the governance of state-owned banks as well as compare the role of boards across different bank ownership groups. The Indian experience could be instructive for the many emerging economies whose banking system contains a mix of state-owned and private banks.

In examining the role of the board of directors, the paper focused on five specific aspects namely, board size, board independence, CEO duality, CEO tenure and nominee directors. The rationale for focusing on these aspects was that the regulatory and legislative provisions for board governance are substantially different between public sector and private sector banks. While all banks irrespective of ownership status are regulated by the Reserve Bank of India (RBI), the country's central bank, public sector banks are *additionally* regulated by the Government of India and are subjected to additional restrictions with respect to the constitution and functioning of their boards. Specifically, as compared to private sector banks, public sector banks are less empowered both in terms of the selecting their board members and appointing their CEOs. In particular, public sector banks have far less flexibility in choosing their outside directors with the GOI nominating most of them. Similarly, the GOI exercises far greater control on the tenure of CEOs in public sector banks and have typically subscribed to the advantages of CEO duality by combining the position of Chairman and the Managing Director. In contrast, most private banks have separated the two positions and have full flexibility to decide the composition of their board and appointing its CEO and Chairman.

In examining the relation between board characteristics and bank performance, while the paper considered some of the standard variables like return on assets and market to book value ratio that have been used in the empirical literature, it also used a variety of bank performance measures related to asset quality related to gross and net non-performing loans which are crucial for the soundness of a banking system.

The empirical analysis was carried out using a sample consisting of all the 25 state-owned banks and the 21 private banks operating in the Indian banking sector covering a period of ten years from 2003 to 2012. The results of the empirical analysis suggested that while board size played an insignificant role in bank outcomes, board independence played a significant role. However, the effect of board independence was negative for public sector banks and positive for old and new private sector banks with the effect being significantly higher for the new private sector banks. The effect of board independence was stronger for market measures than for accounting indicators, suggesting that the market valued the beneficial effects that independent directors can bring from their experience and expertise in the long run. The analysis also revealed that CEO duality had a strong and negative effect on bank performance. This was perhaps because of the perception that combining the post of CEO and chairman is likely to reduce governance oversight or simply because the task of discharging the functions of these two positions may be too onerous for a single person. Finally, the analysis with respect to board composition showed that nominee directors may have a negative effect on bank outcomes, especially with respect to market valuation, as these directors may be more inclined to safeguard the interest of their parent organizations who may be important providers of debt capital, than the interest of the equity holders. The analysis with respect to the tenure of the Chief Executive Office suggested that longer tenure had significant effects in improving bank outcomes especially those related to profitability and market valuation. These positive effects strengthened in the later years of CEO tenure.

The analysis in the paper provided strong evidence that governance structures in banks had a significant bearing on bank outcomes. The findings from the study had some implications for Indian banking system. First, the findings suggested that public sector banks may be more empowered in selecting and incentivizing their board of directors. Second, the results suggested that it may be a worthwhile step to reduce the incidence of CEO duality in public sector banks by separating the posts of the CEO and the chairman. Finally, the findings implied that it may be beneficial to give a minimum tenure to the CEOs, especially to those of public sector banks, to ensure that these CEOs get enough time to implement their visions and strategies leading to better bank outcomes.