The Impact of Corporate Governance Mechanisms on Banks' Financial Performance

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Abstract

The banking industry cannot overlook the significance of Corporate Governance in the modern, liberalised economic climate where the nations are strongly integrated into the global market. Ownership and management must be separated for better corporate governance. Agency issues result from this division of ownership and control. The study discusses techniques for observing and influencing banks' actions to address such issues, as well as those mechanisms' limitations. Reviewing the agency theory, stakeholder theory, and stewardship theory in relation to corporate governance theory. Additionally, it emphasises the necessity of corporate governance in the banking industry generally and in India specifically. With the aid of previous studies, the paper makes a modest effort to demonstrate a connection between corporate governance and financial results and proposes that banks with efficient corporate governance procedures have higher financial performance.

Keywords:

1. Introduction

In any nation's economic life, the banking system is crucial. The stability of a country's banking system has a direct impact on the health of its economy. Without the provision of proper banking services, modern trade and business would be all but impossible. Being the foundation of its economy, India's banking sector has always been crucial in preventing economic downturns. One of the world's best and healthiest financial systems is that of India. The success and ongoing survival of banks depend on maintaining a focus on the basics, adopting the highest level of professionalism, adhering to the rules for lending and investing, adhering to good banking principles, and assuring adequate capital. The domestic corporate sector currently cannot disregard the significance of Corporate Governance in the liberalised economic climate where the nation is strongly integrated into the global market. Corporate governance is a mechanism that may be used today to increase shareholder wealth.

Corporate Governance Definition

The topic of corporate governance is particularly intricate and multifaceted. Its paradigm, diagnosis, and remedies are found in diverse domains such as economics, accountancy, and finance among others because it lacks a cohesive or systematic framework (Cadbury, 2002). A thorough framework must therefore be written in the accounting system of every organisation. Corporate governance is one of the most important elements that affects an organization's overall health and resilience to economic shocks. The fundamental soundness of each component and the linkages between them determines the organization's overall health.

According to Prowse (1995), there are a number of important elements that contribute to a country's financial stability, including good corporate governance, effective marketing discipline, strong prudential regulation and supervision, accurate and reliable accounting and financial reporting systems, a sound disclosure regime, and a suitable system for protecting savings deposits. Corporate governance has been analysed and described in a variety of ways by academics and professionals. However, they all led to the same destination, resulting in agreement on the definition. According to Coleman and Biekpe (2006), corporate governance is the relationship between an organisation and its shareholders, or, in a broader sense, the relationship between an organisation and society at large. However, Mayer (2000) provides a definition with a broader perspective and claims that it refers to the totality of the procedures, frameworks, and data used to control and monitor an organization's management. Corporate Governance is a framework that governs how businesses are run, according to the Organisation for Economic Cooperation and Development (1999). On the basis of this system, guidelines are provided for the division of skills and duties among the parties involved (the board of directors, the supervisory board, the management, and the shareholders), and rules and procedures are developed for making decisions on corporate matters. Corporate governance is generally understood to refer to the controls, procedures, and relationships that govern corporations.

Mechanisms for Corporate Governance

The fact that ownership and management are separated has the effect of giving somebody other than the shareholders themselves control over daily operations. There is a propensity for management to run the company in their own interests rather than that of shareholders as a result of the separation of ownership and control (Jensen and Meckling, 1976; Fama and Jensen, 1983). This is known as an agency problem. This gives managers the chance to establish illegal empires and, in the worst cases, engage in outright expropriation. The research has offered a number of recommendations for how to lessen the issue (Jensen and Meckling, 1976; Hermalin and Weisbach, 1998). The following discussion includes some of the tools and their limitations for observing and influencing bank behaviour.

Investors: Investors are essential to the supply of corporate governance. By directly voting on important matters like mergers, liquidations, and fundamental changes in business strategy, small or diffuse shareholders can influence corporate governance. They can also do this indirectly by electing the boards of directors that will represent their interests and oversee the various managerial decisions. A prominent method for balancing managers' interests with those of shareholders is the use of incentive contracts. The Board of Directors has the authority to discuss managerial compensation in order to reach specific goals. Small shareholders can therefore directly influence corporate governance through their ability to vote and indirectly through the board of directors they elect.

Debt Holders: Debt buyers lend money in exchange for a guaranteed stream of payments and a number of additional corporate behaviour covenants, such as the worth and risk of the company's assets. Debt holders often have the power to reclaim collateral, initiate bankruptcy procedures, participate in the decision to reorganise, and oust managers if the corporation violates certain covenants or defaults on the payments. Therefore, debt holders may also directly, if not indirectly, exercise Corporate Governance through their legal rights.

Framework for Corporate Governance Theoretically

The agency theory, stakeholder theory, and stewardship theory are the three main theories of corporate governance that Sanda et al. (2010) identified in their study titled Corporate Governance Systems and business financial performance in Nigeria. These three ideas are presented below. Theory of Stakeholders: One of the first proponents of stakeholder theory, Freeman (2010) [19], recognised stakeholder groups' formation as crucial organisational factors that needed to be taken into account. Freeman further advocates a re-engineering of theoretical viewpoints that recognises the various stakeholder groups and goes beyond the owner-manager-employee stance. Stakeholders are any group or person that can affect or is affected by the accomplishment of the organization's goals, according to Freeman (2010) [19]. According to Freeman (1999), organisations must focus on all relationships, not just those that can influence or be affected by the accomplishment of the organization's goals. In other words, the idea of stakeholder management is inherently practical. No matter what the firm's goal may be, an efficient firm will handle the crucial relationships. Stewardship Theory: According to stewardship theory, directors typically have interests that are aligned with those of shareholders. According to Donaldson and Davis (1991), individuals who hold organisational roles are thought to be driven by a desire to succeed and experience intrinsic fulfilment through the execution of inherently difficult tasks, to exercise authority and responsibility, and to be recognised by peers and superiors. According to stewardship theory, there is no fundamental issue with executive motivation (Cullen et al., 2006). Donaldson and Davis suggested that personal perception drives individual calculative action by managers, tying individual self-esteem to corporate prestige, citing the work of Silverman (1971). This would imply that where managers get intrinsic enjoyment from carrying out their responsibilities, extrinsic incentive contracts are less significant.

Agency Theory: The corporate governance literature is overwhelmingly dominated by the agency theory. According to Daily et al. (2003), there are two elements that affect the popularity of agency theory. First off, the idea is theoretically straightforward and simplifies the actors in a firm to just two: managers and stockholders. Second, it's often believed that people are selfish and self-interested. In its most basic form, agency theory describes how ownership and control separation causes agency issues. It offers a practical explanation of relationships in which the interests of the parties are in conflict and can be brought closer together via appropriate monitoring and a carefully thought-out compensation scheme (Davis et al. 1997). Eisenhardt (1989) describes two streams of agency theory that have evolved over time: a positivist perspective where they are likely to have competing aims, and the principal-agent connection where both behave cooperatively.

Corporate Governance is Required in the Banking Sector

We are dealing with a wide range of transitional difficulties as we advance towards becoming a global economy. These can be appropriately classified as structural modifications to market institutions that have increased investor, banker, and general public understanding. The economy has grown very slowly in spite of economic reforms including privatisation, liberalisation, and the removal of the licencing raj. An uneven approach prevented growth from taking root. The largest shareholders of corporations continue to control the government and "para-state" entities like privatisation funds. As a result, a small group of people known as internal owners continue to hold de facto authority, while external owners lack the ability to exert sufficient control over the companies and, as a result, are unable to secure adequate profits for themselves (Burchard, 2011).

The majority government ownership of banks in developing nations is another significant influence in the banking sector. In such circumstances, government agencies and numerous rules based on stereotypical procedures serve as banks' primary guides. The concept of accountability is less clear because government employment undermines the spirit of competition. In developing, emerging, and transitional economies, the demand for corporate governance results from issues with ownership and control as well as from the need to ensure that the intended aim of corporate governance is achieved. Many times, rising and developing economies struggle with problems such as a lack of property rights, mistreatment of minority shareholders, breach of contract, asset theft, and self-dealing. The main components of a financial governance framework would be ownership patterns, regulatory environments, societal pressure, and wide structure. Government ownership does give banks their fundamental strength, but structural inefficiencies and a lack of managerial autonomy seem to have hurt our banks' capacity to compete successfully in the market today, especially in the public sector (Indiresan, 2013).

Over the years, banks and financial institutions have played a crucial role in the nation's economic development. Banks in the public sector have had a significant impact on economic growth. These institutions have been gradually becoming corporatized over the past few years, and as a result, corporate governance challenges in banks will become more important in the years to come. Given the significance of the banking industry, the practise of corporate governance and how it promotes greater transparency and aids in the sector's general expansion are of major concern.

Governance of Corporations in Indian Banks

In India, the first official steps towards corporate governance were taken as a self-regulatory measure rather than in response to a corporate scandal like World Com or Enron or any violation of the law. After the Cadbury committee report on the monetary elements of corporate governance was published in the UK in 2002, corporate governance can be traced to India. The voluntary code of corporate governance in India was first developed by the Confederation of Indian Industry (CII). The SEBI Committee, which is chaired, has been the next crucial piece in the Indian case. The listing agreements with stock exchange now include a new clause 49 that was introduced by the Committee. This suggestion marked a turning point in India's corporate governance history.

The RBI Standing Committee on International Financial Standards and Codes, which presented its Report in 2002, is where the concept of corporate governance in banks first emerged. The Group studied public sector banks and found that the most crucial step in strengthening the governance mechanisms in these organisations is to transfer the actual governance responsibilities from the relevant administrative ministries to the boards and to streamline the director appointment procedure (Hemal, 2011).

Financial Performance and corporate governance

By limiting the expropriation of dominant owners and ensuring improved decision-making, stronger corporate governance is believed to result in higher financial performance. News of enhanced Corporate Governance may cause the firm's value to react immediately in anticipation of such an improvement. However, there is only a limited amount of quantitative data to show a relationship between corporate governance standards and financial performance (Imam and Malik 2007). Fewer expropriations of business assets by managers or controlling shareholders is a sign of good governance, which helps to improve resource allocation and financial performance. They will see lower costs of capital, which is another factor contributing to greater financial performance, because investors and lenders will be more eager to invest in businesses with solid governance. The partnerships with such enterprises are likely to be more lucrative, equitable, and long-lasting than those with businesses that have less effective governance, so other stakeholders, including employees and suppliers, will also want to be identified with and establish commercial relationships with them.

There are also clear repercussions for the economy as a whole. Because the economy is less susceptible to a systemic risk, economic growth will be more enduring. The capital market will also be expanded and developed, which is necessary for long-term economic growth, with improved investor protection at the business level. The development of an equitable and corrupt-free society also depends on effective corporate governance. Corruption and corruptive synergy between business and political circles thrive in major enterprises with poor corporate governance. A more advantageous business environment for smaller businesses and more fair wealth distribution may arise from less expropriation of minority shareholders and less corruptive relationships between powerful corporations and the political system (Magdi and Nadareh, 2002). According to a poll conducted by McKinsey and firm in Malaysia in 2002, Adams and Mehran (2003) reported that 78% of professional investors said they would be willing to pay more for a firm with strong governance. These investors were typically willing to pay a premium of 20% to 25% on average. Many academics have tried to conduct more thorough research into the connection between effective governance and financial performance.

Previous Research on the Topic

According to the agency hypothesis, when managers are properly overseen, agency costs are reduced, which should result in higher stock prices or better long-term financial performance (Albanese et al., 1997). However, as Gompers et al. (2001) imply, the agency explanation may be used to explain the evidence of a positive correlation between corporate governance and financial performance. The most researched governance practises in respect to the connection between corporate governance and financial success include board composition, board size, and shareholder activity.

Board Membership: It has been suggested that changing the makeup of the board could help to solve the agency dilemma (Weisbach, 1988). The results of empirical studies on the impact of board composition and structure on performance are typically contradictory or inconsistent with the agency cost argument. While some studies (Vafeas, 1999; Pfeffer and Salancik, 2003) find better performance for companies with boards of directors dominated by outsiders, other studies (Weisbach, 1988; Daily and Dalton, 1992; Rosenstein and Wyatt 1997; Bhagat and Bolton 2008) find no such connection in terms of accounting profits or firm's financial performance. 54 empirical studies of board composition and 31 empirical studies of board leadership structure, together with their correlations to firm financial performance, were analysed by Daily and Dalton in 1992. They find less evidence of a connection between board leadership or composition and business performance. The studies by Hermalin and Weisbach (1991) and Bhagat and Black (2002) both demonstrate this.

Board Size: According to Yermack (1996), there is a reasonably obvious inverse relationship between board size and financial performance. For a sample of small and medium Finnish businesses, Eisenberg, Sundgren, and Wells (1998) found a comparable pattern. Additionally, their research showed a negative correlation between board size and financial performance. Limiting board size is thought to improve financial performance since the advantages of larger boards' more monitoring are offset by the worse communication and decision-making of larger groups, according to studies by Lipton and Lorsch (1992) and Jensen (1993). According to Hermalin and Weisbach (1991), a large board is more likely to struggle with free-rider concerns among directors when it comes to their oversight of management and to be less effective in substantive debate of important topics. An empirical analysis of companies listed on the Singapore Stock Exchange was done by Mak and Li in 2001. They claimed that the estimating approach has an impact on the direction and importance of the association between board size and financial success.

Participant Activities: There is scant proof, according to Baysinger and Butler (1985), that shareholder-driven resolutions on corporate governance improve financial performance. Smith and Watts (1992) found that the shareholder activities of the California Public Employees Retirement System had a positive performance impact. Huson et al. (2004) demonstrated that financial institutions could be somewhat successful in pressuring target corporations to follow their corporate governance recommendations. They also discover that the sort of governance issue that is being targeted determines whether any short-term valuation effects are present. In contrast to institutional investors' suggestions, which have a modest but large negative impact on stock prices, individual shareholder proposals have small, positive announcement impacts, according to Gillan (2006). According to empirical research on shareholder activities in the United States, their influence on a company's financial success is essentially nonexistent (Black et al., 2003).

Conclusion

The unique characteristics of banking organisations call for a comprehensive understanding of corporate governance, where regulation of banking activities is necessary to protect depositors. The safeguarding of depositors in a regulated the environment is usually provided by a system of prudential control in developed economies, but in developing economies, this protection is undermined by the absence of properly trained supervisors, insufficient disclosure requirements, the high cost of raising bank capital, and the existence of distributional cartels. Due to the unique nature of the activities performed by banks, they encounter numerous issues in the domain of corporate governance. Due to the specific characteristics of bank holdings, there are numerous embedded conflicts in the Indian context. There is controversy around the appropriate criteria to use for implementing good corporate governance in banks. In this context, central banks are crucial. In order to enforce Corporate Governance principles in numerous nations around the world, the Basel Committee's advice paper is of utmost importance. Best Corporate Governance practises for banks may include acknowledging that times are changing, putting in place an efficient, capable, and trustworthy board of directors, creating a corporate code of ethics for the banks themselves, considering creating a position for the chairman of the board, having an efficient and operational audit committee, compensation committee, and corporate governance committee in place, and considering efficient boa

Furthermore, the complexity of the banking industry supports the framework for corporate governance as a crucial component for the vigilance of its regulations. According to the literature, banks with efficient corporate governance systems perform financially better.

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