## CHAPTER 4

### LITERATURE REVIEW

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>4.2</td>
<td>The General Study</td>
</tr>
<tr>
<td>4.3</td>
<td>Corporate Governance in Banking</td>
</tr>
<tr>
<td>4.4</td>
<td>Knowledge Gap</td>
</tr>
</tbody>
</table>
4.1: **INTRODUCTION**

Corporate Governance is a vast topic which has been studied from many angles by many scholars. This chapter includes the studies done in the area of corporate governance and also studies related specifically to the banking sector.

4.2: **THE GENERAL STUDY**

In the study\(^1\), the author Margaret Blair (1995) has expressed the opinion that managers view employee wages as a cost to be reduced, yet, "the return on firm-specific human capital is part of what society as a whole should want to see maximized." Employees are much more likely to participate in cost cutting and innovation if they are confident they will share in the wealth created. Corporate governance discussions need to recognize the importance of employees to wealth creation. Their firm specific investments should be recognized "through formal compensation schemes organizational forms, or other arrangements that place significant amounts of the company's equity under the control of the at-risk stakers and that assign control responsibilities comensurate with their equity stake to this group."

The study\(^2\) conducted by Cyert, Richard, Sok-Hyon Kang, Praveen Kumar, and Anish Shah (1997) observed a sample of 1,671 firms. They found that CEO compensation is about 2.6% less where median stock ownership by the compensation committee was twice that of an otherwise similar firm.

---

\(^1\) Blair Margaret,(1995) Rethinking Assumptions Behind Corporate Governance Challenge, Vol. 38 Issue 6, p12

\(^2\) Cyert, Richard, Sok-Hyon Kang, Praveen Kumar, and Anish Shah,(1997).Corporate Governance, Ownership Structure, and CEO Compensation
Compensation was also positively correlated to a greater portion of outside directors.

The series of articles\(^3\) in The Economist (2004) surveys the types of markets and monitors by country; the rise of institutional owners and regulations which limit their ability to act; recent developments in Germany, Japan, UK and US; changing role of boards; and increased activism by institutional investors such as CalPERS. Cites Campbell Soup as a model. Board members are independent and are paid in company shares. Senior managers are required to hold shares worth three times their annual salary. The firm has no poison pills or anti-takeover devices. It talks often with institutional investors and actively votes the proxies of shares held by its pension fund in other firms.

4.3: CORPORATE GOVERNANCE IN BANKING

Y R K Reddy and Yerram Raju\(^4\) say that corporate governance is a journey for which a course has to be chartered, procedures have to be evolved and the best practices have to be developed to ensure effectiveness for the purpose it is intended. The stakeholder is the centre of corporate activity. The employees, customers, creditors, neighbours, suppliers, competitors, governments, local authorities, management and citizens, constitute its firmament or lifespace. Accountability, equity in the advancement of competing interests and value creation for the stakeholder are the focus areas.

\(^3\) Corporate Governance Survey The Economist, January 29, 1994, p. 3-18.
\(^4\) Y R K Reddy and Yerram Raju (2000), Corporate Governance in Banking and Finance, Tata McGraw Hill, New Delhi
The study\textsuperscript{5} by Hennie van Gruening and Sonja Brajovic-Bratanovic provides a framework for the identification and allocation of tasks to the key player in the risk-management process. It examines the rapid innovations in financial markets and internationalization of fund flows that have transformed the face of banking.


The first article in this section, "The Corporate Governance of Banks," describes corporation as a set of contractual arrangements among the various claimants to the products and savings generated by business. In the article\textsuperscript{7}, the authors, Jonathan R Macey and Maureen O'Hara compare the two models i.e. Anglo-American vs Franco-German model of corporate governance. They also discuss the nature and purpose of fiduciary duties as they are the mechanisms invented by the legal system in the unspecified terms of shareholders' contracts. The article states that the problem of CG is rooted in the paradigm of the separation of shareholders' ownership and control in the modern corporation. Effective risk management is perceived to be one of the means to achieve sound corporate governance. The directors should feel obligated to provide continuous oversight of the companies on whose boards they are appointed. The article also stresses the need for the


\textsuperscript{6} V Subbulakshmi (Ed) Corporate Governance in Banks - An Introduction April 2004 Paper Back

\textsuperscript{7} Ibid
directors to face litigation if they are found deficient in performing their duties.

The second article, “Is Corporate Governance Different for Bank Holding Companies?” discusses the main differences between corporate governance in a bank holding company and in a corporate. The authors, Renée Adams and Hamid Mehran stress on the need of corporate governance to enhance accountability and efficiency. The authors then proceed to discuss internal governance structures and shareholder block ownership. A sample of 35 public traded bank holding companies is taken and analysed in terms of board size and composition, board activity, CEO compensation structure, CEO ownership and block ownership. The findings of the study are: Board structure, ownership structure and compensation structure are interdependent; Bank boards are generally larger than those of manufacturing firms with more outside directors; Bank boards have more committees that meet more frequently than manufacturing firm boards; Bank boards rely less on long-term incentive based compensation such as stock options; and Institutional holding in Bank holding companies is less compared to that of manufacturing firms. In effect, it was found that governance reforms are found to be industry specific.

The next article by Dr. Ambrish Gupta, "Basel II and Role of Pillar 2: Ensuring High Standards of Corporate Governance," introduces the Basel II Accord. It states the three pillars of Basel II:

Pillar 1: Minimum capital requirements for credit, market and operational risks

---

8 Ibid
9 Ibid
Pillar 2: Supervisory review process and its role in Corporate Governance; Pillar 3: Market Discipline through enhanced disclosures. The author then explains on the Corporate Governance issues in banks.

The last article, "Bank Performance and Corporate Governance," is a speech given by Susan S Bies Member, Board of Governors, US Federal Reserve System. In her speech, the author begins by discussing the financial condition of the US Banks. She states that Corporate Governance is an essential element of a strong risk management process. Directors should bear the additional responsibility of periodical review of their initial assessment to ensure integrity of the management at the highest level. She strongly argues in favor of sound ethical practices in protecting the reputations of banks. The article also explains the significance of quality of corporate accounting practices in determining the efficiency of the markets.

The next section is on "Corporate Governance of Banks in Developing Economies."

The first article, "Bank Governance: The Balance between Official Oversight and Market Discipline," is by Luigi Passamonti. He states instances of corporate distress have prompted regulatory authorities to come up with a set of standard guidelines to ensure good corporate governance and avoid such episodes in future. Corporate governance in banks plays a significant role in ensuring financial stability. The article highlights the Basel guidelines issued in September 1999 in this regard. It specifies the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's particular risk profile and control environment.

---

10 Ibid
11 Ibid
12 Ibid
The next article, "The Role of Central Bank in Promoting Corporate Governance," is a speech by Dr. Mahmoud Abul Ayoun Governor of Central Bank of Egypt. In this speech, he states that the governance is achieved through a set of legal, accounting, financial and economic rules and regulations. Governance is required to ensure the efficiency and integrity of the members of the board of directors. He then elucidates the role of a central bank in ensuring integrity in the banking sector.

The next article, "Corporate Governance in Financial Intermediaries," discusses the role of financial institutions including banks. The author M K Datar suggests different governance mechanisms for institutions and markets. He compares issues in the working of large banks and corporations. He states that the bank regulators have control over the appointment of chief executives and remuneration to full time directors.

The next article, "Public Sector Banks and Governance Challenge: Indian Experience," is a speech by Dr. Y V Reddy Governor, Reserve Bank of India delivered at the World Bank. He elucidates the following issues: Dilution in government's equity shareholding in public sector banks.
Board level committees including management committees for critical areas.
Audit committees of the boards.
He also discusses the important recommendations of different advisory groups on Corporate Governance in Banks set up under the heads of Dr. R H Patil, M S Verma and Dr. A S Ganguly.
The next article[^1] "Best Practices of Corporate Governance in Banks," gives a brief overview of generally accepted principles of Corporate Governance and the current regulatory issues of CG in the Indian Banking Industry. The author, V Subbulakshmi, explains the ten commandments of corporate governance that are widely recommended to ensure good governance in banks. The article discusses the governance issues in regard to Board size, board composition, CEO compensation, Board responsibilities and duties. The implementation procedure that is to be adopted to ensure high standards of governance is also discussed.

Abhiman Das, Saibal Ghosh[^2] examined the issue of corporate governance in the Indian banking system, using data on banking systems for the period 1996-2003. Their findings revealed that CEOs of poorly performing banks are likely to face higher CEO turnover than CEOs of well performing ones. This paper evaluates corporate governance in the banking industry in an emerging country where the focus is on corporate governance outcomes rather than on corporate governance mechanisms. This study examines the relationship between two variables i.e. the turnover of bank chairmen and bank performance.

The estimation procedure comprises of two sets of results which are

1. The relationship between CEO turnover and performance in public sector banking system, and
2. 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 of individual banks has been obtained from the audited

[^1]: Ibid
annual reports of such banks. A negative correlation has been observed between the dependent variable and performance which suggests that 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 subsequent analysis encompasses 62 banks i.e. 27 public sector banks, 10 foreign banks, eight new private banks and 17 old private banks. It was observed that 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.

Rajesh Chakrabarti, William L. Megginson, Pradeep K. Yadav have conducted an extensive literature study\textsuperscript{18} of corporate governance practices in Indian organisations. Even though the legal system in India provides some of the best investor protection in the world, maladies like slow, over-burdened courts makes application of law and regulation difficult and sometimes impossible. Widespread corruption continues to eat through and weaken the Indian system. The banking sector in India has one of the lowest proportions of non-performing assets. This means that corporate fraud is still within control.

According to this study, the major chunk of Indian industry consists of family enterprises and also SMEs which continue to play a big role in the development of the Indian economy. However, research shows that these SMEs have very poor concern for regulation and law relating to corporate governance.

This research paper has been divided into six sections.

The first section is the introduction wherein the authors briefly talk about the Indian corporate sector and corporate governance practices. The second section makes an assessment of both the legal and institutional aspects of investor protection and corporate governance in India. It provides a rather optimistic view of the investor protection norms in India. Section 3 describes the evolution of corporate governance in India, while the fourth section observes the changes in corporate governance since liberalization. Section 5 reviews the recent literature on corporate governance in India. Section 6 summarizes the report and gives conclusions.

The authors have explained each section in detail, starting with the assessment of the institutional environment in India. They have quoted data taken from various research articles.

In the second section, the authors have explained the regulations and laws governing business organizations in India.

Where enforcement of corporate governance laws and regulations is concerned, the authors quote "The World Bank’s 2004 Reports on the Observance of Standards and Codes (ROSC) finds that while India observes or largely observes most of the principles, it could do better in many areas, including the use of nominee directors, the enforcement of laws and regulations pertaining to stock listing on major exchanges, insider trading, and dealing with violations of the Companies Act."

In the third section, the authors have written about the evolution of corporate governance in India.

\[19 \text{ Ibid} \]
\[20 \text{ Ibid} \]
\[21 \text{ Ibid} \]
The fourth section\textsuperscript{22} talks about the recent developments in corporate governance in India. It talks about the various committees set up to look into this issue and also the various reports that these committees have submitted with their observations and conclusions. This section also explains Clause 49 of the Listing agreement of the SEBI, saying that the provisions contained in this clause are very similar to those that are present in the Sarbanes-Oxley Act of the United States of America. Corporate governance in banks is also briefly explained in this section.

Section 5\textsuperscript{23} and 6\textsuperscript{24} talk about the findings and conclusions of this study. The authors conclude by saying “India has one of the best banking sectors in Asia, in terms of non-performing assets with the banking sector. But even though the Indian legal system provides one of the highest levels of investor protection in the world, the reality is very different with slow, overburdened courts and widespread corruption. Consequently, ownership is still concentrated and family business groups continue to be the dominant business model in India.

This research paper\textsuperscript{25} by Robert W. McGee begins with an overview of some basic corporate governance principles as identified by the OECD, World Bank and IMF. It then proceeds to examine how these principles are being applied in selected Asian countries. The author starts by quoting from The Center for International Private Enterprise (2002) which lists some of the main attributes of good corporate governance which include:

- Reduction of risk

\textsuperscript{22} Ibid
\textsuperscript{23} Ibid
\textsuperscript{24} Ibid
\textsuperscript{25} Robert W. McGee,(2008) Corporate Governance in Asia: A Comparative Study
- Stimulation of performance
- Improved access to capital markets
- Enhancement of marketability of goods and services
- Improved leadership
- Demonstration of transparency and social accountability

The author also explains findings from reports and research papers. However, the main part of this study concentrates on corporate governance case studies undertaken in Asian countries. It talks about corporate governance from the following points of view:

- Minority Shareholder protection
- Structure and responsibilities of the Board
- Auditing and Accounting
- Transparency of Ownership and Control

In the study26 by Nur Ashikin Mohd Saat, Yusuf Karbhari, Saed Heravi, and Annuar Md Nassir, the authors examine the authority of independent directors on the board on various factors that include firm value and the factors that strengthen independent directors’ performance of fiduciary duties. This research was conducted using 221 samples of Malaysian listed companies and emphasized on the significance of regulating the appointment of independent directors.

### 4.4: Knowledge Gap

Even though the above literature revolves mainly around Corporate Governance as the main subject, there are very few studies conducted on this subject in India especially in the Banking sector. Secondly, there has been no comparative analysis of different types of banks in the Indian

---

Banking Sector. The researcher has attempted to fill this gap as this study is centered on Corporate Governance in the Indian Banking Sector. It is also a comparative analysis of the three main types of banks i.e. Private Banks, Public sector banks and Foreign banks.