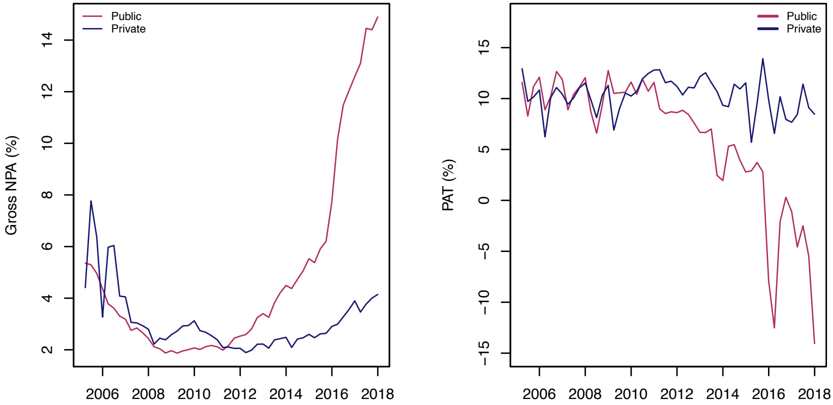
Risky business: Corporate governance in Indian banks

Aakriti Mathur
IHEID, Geneva

Emerging Markets Finance conference
December 18, 2020

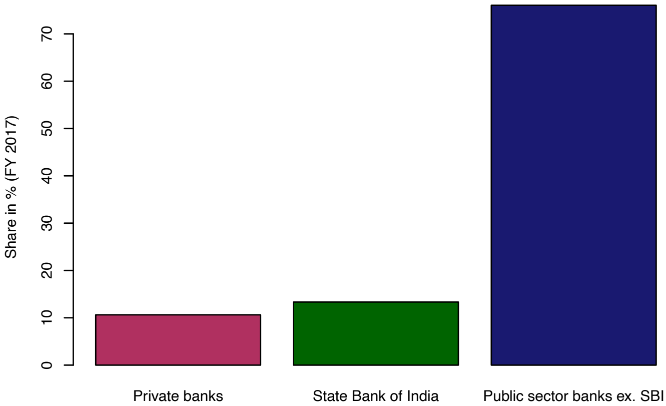
Post-crisis developments in Indian banking: Balance sheet performance

Figure: Gross NPA/gross advances (left), and profits after tax (right) for all Indian listed banks



Post-crisis developments in Indian banking: Severe lapses in oversight

Figure: Share of private and public sector banks in aggregate loss from frauds totalling $2.5bn (2017)



Note: Source: IiAS (2018)

Increased discussions on corporate governance in recent years

Bank Boards Bureau set up in Feb 2016

It is unclear that the boards of most of these banks have the required sense of purpose, in terms of their focus on business strategy and risk management, in being able to provide oversight to steer the banks through their present difficult position. The boards are disempowered, and the ***selection process for directors is increasingly compromised. Board governance is consequently weak.*** *(...)*

The Report proposes that the ***Government distances itself from several bank governance functions*** *which it presently discharges.*

- Report of The Committee to Review Governance of Boards of Banks in India
May 2014

Research questions

1. Quantitatively analyse the differences between Indian public sector and private sector banks
2. How do shareholders respond to turnover in board of directors? Specifically: CEOs and independent directors
3. Is there a link between bank riskiness and board incentives?

Literature

- **Link between bank risk taking and board structures**
  - **Sarkar and Sarkar, 2018**; **Sarkar et al., 2019**; Bernile et al., 2017; Berger et al., 2014; Aebi et al., 2012; **Hau and Thum, 2009**
- **Director turnover and stock market response**
  - **Pessarossi and Weill, 2013**; **Nguyen et al., 2015**; Huson et al., 2004; Rosenstein and Wyatt, 1990; Bonnier and Bruner, 1989
- **Upper echelons theory**
  - Hambrick and Mason, 1984; Wang et al., 2016
- **Link between bank performance and**
  - Share of independent directors (Adams and Ferreira, 2007), CEO characteristics (Falato et al., 2015; King et al., 2016), diversity (Adams and Ferreira, 2009; Ferrari et al., 2017), and compensation (Chen et al., 2006; Fahlenbrach and Stulz, 2011; Anginer et al., 2016; Ongena et al., 2018, among others).

Roadmap

- Indian bank boards
- Data & descriptives
- Are changes in the board "news"?
- Link between board incentives and bank riskiness
- Conclusions and next steps

Structure of bank boards

- Interest in: Hiring, firing, retiring, and compensation
- Use the fact that board structure is independent of individual state bank's characteristics

Focus	**State banks**	**Private banks**
Board composition	Bank Nationalization Act, 1969 & 1981	Nomination Remuneration Committee (NRC)
Appointment of CEOs and indep. directors	Ministry of Finance - BBB recommendations non-binding - Limits on age, expertise, tenure, etc.	Companies Act/SEBI/NRC
Compensation to CEOs	Ministry of Finance Salary + variable pay (performance matrix)	Companies Act/NRC Salary + variable pay + stocks
Compensation to indep. directors	Government policy across PSUs	Companies Act/NRC

Characteristics of the median Indian bank board, 2006–2017

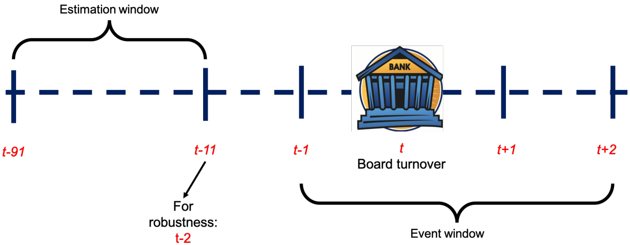
NSEInfoBase, 2006–2017, from bank annual reports

Variable	**Range**	**State**	**Private**	$\overline{x}_s - \overline{x}_p$ **significant?** $(\alpha = 0.05)$
Panel A: Median director				
Age				
Active director	28 - 82 yrs	58 yrs	61 yrs	Yes
Length of tenure	0 - 25 yrs	3.00 yrs	6.00 yrs	Yes
CEO tenure	1 - 10 yrs	2.00 yrs	5.00 yrs	Yes
Chairperson tenure	1 - 19 yrs	2.00 yrs	7.00 yrs	Yes
Board chair in other firms	0 - 26	2.50	1.00	Yes
Director in other firms	0 - 22	2.00	3.00	Yes
No. of meetings attended	2 - 26	9.83	7.8	Yes
No. of sub-committee positions held	0 - 12	4	2	Yes
Total remuneration (based on real, 2015 INR)	$1168-$315,000	$15,010	$51,000	Yes
Panel B: Median bank				
Size of board	1 - 19	11	10	Yes
Share hired after CEO	0 - 93%	30%	55%	Yes
Share of executive directors	0 - 83%	23.08%	12.5%	Yes
Share with relevant education	0-100%	56%	70%	Yes

Are changes in the board "news"?

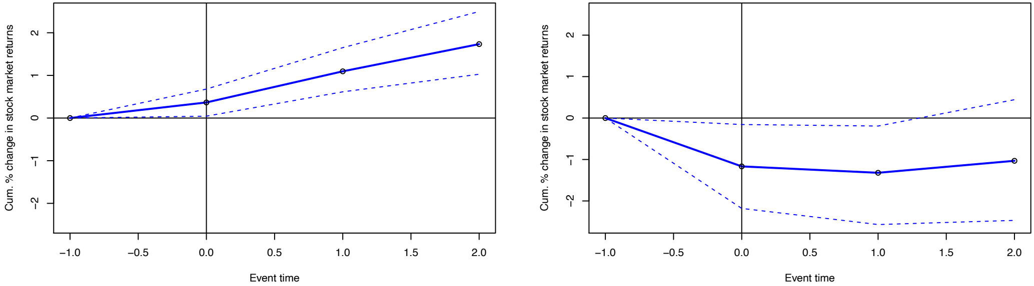
- **Event**: CEO and independent director appointments and cessations
- **Standard market model**: Obtain CARs for bank b on day t, with R_{mt} as the market return (**Nifty50** or NiftyBank) from:

$$R_{bt} = \alpha_b + \beta_b R_{mt} + \epsilon_{bt} \tag{1}$$



- **Theoretical mechanisms**: Ability, Information, Scapegoat hypotheses

Event study results: CARs from CEO turnover



Left: State banks *Right:* Private banks

- State bank shareholders anticipate better future bank performance in response to CEO turnover, potentially due to perceived improvement in managerial quality

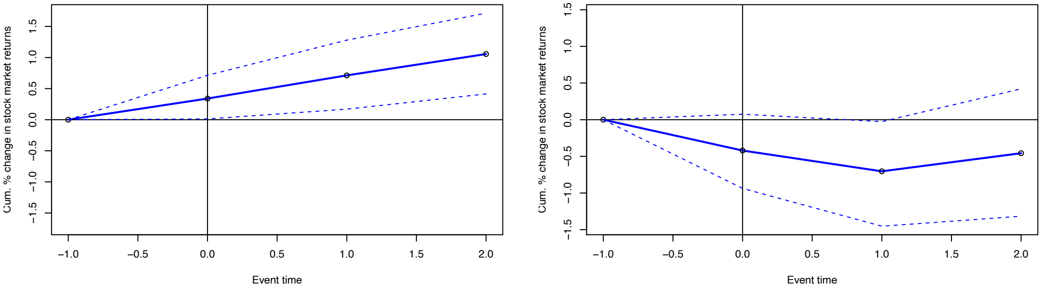
Explaining cross-sectional CEO CARs in public sector banks

$$
\begin{aligned}
\text{CARs}_{dbt}^{(-1,+2)} = {} & \alpha + \beta_1 \text{CEO age at appt}_{dbt} + \beta_2 \text{CEO gender}_{dbt} + \beta_3 \text{CEO education}_{dbt} \\
& + \beta_4 log \text{ assets}_{dbt-1} + \beta_5 \text{return on assets}_{dbt-1} + \beta_6 \text{capital surplus less 8\%}_{dbt-1} \\
& + \beta_7 \text{net NPA}_{dbt-1} + \beta_8 \text{board size}_{dbt-1} + \beta_9 \text{number of meetings}_{dbt-1} \\
& + \epsilon_{dbt} \qquad (2)
\end{aligned}
$$

for director d in bank b in year t. Balance sheet variables are as of last financial year.

- Balance sheet characteristics matter more on average than director specific factors, except gender and education
- Stock prices respond by less to CEO turnover in banks with healthier balance sheets

Event study: CARs from independent director turnover



Left: State banks (Appointments) *Right:* State banks (Cessations)

- Shareholders value the monitoring role played by independent directors for state banks; no such significant response for private banks (similar to Nguyen and Nielsen, 2010; Rosenstein and Wyatt, 1990)

Board incentives and riskiness: Hypotheses

Board (CEO) incentives determined to hiring, firing, retiring, and compensation:

H1: **Short tenures** and **design of variable pay** at PSBs incentivizes CEOs to undertake higher risks and/or lower monitoring

For private banks, higher variable pay aligns CEO incentives with shareholders; but lack of constraint on tenures can either allow them to take a longer-term view of profitability or capture the Board and reduce efficiency in monitoring

H2: **Higher age of CEO** in PSBs associated with lower bank risk

Specification

$$
\begin{aligned}
log\ z - \text{score}_{b,t} = \alpha_b + \gamma_t + \boldsymbol{\beta_A}\text{board variables}_{b,t-1} + \boldsymbol{\beta_B}\text{board variables}_{b,t-1} \times \text{D.public}_b \\
+ \beta_1 log\ \text{total assets}_{b,t-1} + \beta_2\text{net NPA/loans}_{b,t-1} + \beta_3\text{NII}_{b,t-1} \\
+ \beta_4\text{NIM}_{b,t-1} + \beta_5\text{loans/assets}_{b,t-1} + \beta_6\text{sensitive sector credit/assets}_{b,t-1} \\
+ \beta_7\text{non-resident FII}_{b,t-1} + \epsilon_{b,t} \qquad (3)
\end{aligned}
$$

where for bank b in quarter t:

- $z - score_{bt}$: $\text{ROA}_{bt} + (\text{K/TA})_{bt}/\sigma_{bt}^{ROA}$ [$\uparrow \implies$ less risky bank]
- Board variables: CEO and board age, tenure, compensation (and its components), risk sub-committee meetings, share female, share with relevant education, average board size
- α_b, γ_t: Bank and time fixed effects (several alternate definitions)

Main results

- Increasing CEO tenure, specially relative to the board, is associated with lesser riskiness for public banks and higher riskiness for private banks
- CEO age is in general associated with reduced bank risk, which is consistent with age being a proxy for past experience
- A higher share of salary (or cash) component and lower variable component of CEO pay are linked to lower riskiness for public banks
  - Design of variable pay in public banks provides the CEO with incentive to expand aggressively and take on higher risk during her short tenure (which is capped by retirement).

Conclusions

- How are state bank board different from public bank boards? Bring this question to the data *á la* Sarkar and Sarkar (2018)
- Shareholders respond significantly to board turnover in state banks (specifically, CEO and independent director)
- Increasing CEO tenure and age, and decreasing the variable component of CEO pay is linked to lower bank riskiness in public banks
- Next steps for fine tuning the analysis:
  - Event study: Internal vs. external candidates; restrict sample to "switching" CEOs; Announcement of govt. appointees
  - Panel: Alternate measures of riskiness

Thank you.

aakriti.mathur@iheid.ch