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Impact of Country Level Corporate Governance on Profitability of Banks in India

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ABSTRACT

In the recent years, there has been an uptick in the level of concern over corporate governance. This is mostly attributable to the widespread collapse of major corporations in both the local and international arenas. Both proactive and reactive actions have been adopted by governments in reaction to the growing number of instances of financial crisis in an effort to achieve stability in the sector. Nevertheless, the stability of banking operations continues to be questionable despite the interventionist responsibilities played by the government. The primary objective of this research is to investigate the effect that corporate governance at the national level has on the profitability of Indian banks using a representative sample of 33 financial institutions, including 21 private and 12 public banks. Descriptive statistics, correlation analysis, and regression analysis of two-way variable intercept random effect model, and robustness checks including robust regression are utilized in the study. The purpose of study is to assess; via the use of empirical research methods, the impact that good corporate governance has on the profitability of the banking sector in India. Return on Equity (ROE), Return on Assets (ROA) and Net Interest Margin (NIM) were accepted as proxies for profitability in the banking industry. The empirical evidence presented in the paper demonstrates that good corporate governance has a considerable influence on the profit performance of the Indian banking sector. In the context of India's status as a developing economy, this study offers new research that establishes a relationship between country-level corporate governance and the profitability of banking institutions.

Key Words: Corporate Governance, Indian Banks, Profitability, Return on Equity (ROE), Return on Assets (ROA), Net Interest Margin (NIM).

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1. INTRODUCTION

In India, the banking system is evolving and emerging. Significant changes have been to the Indian banking system, particularly after the 1990s. The goal of the 1990s liberalization reforms was to increase the productivity, profitability, and efficiency of the banking system (Ghosh, 2016). The emphasis on enhancing the banking landscape's competitive advantage through the expansion and development of the nation's financial network to permit the participation of private and foreign banks is one of the key characteristics of the liberalization policy reforms. Since then, the steady and consistent growth in the gross domestic product (GDP) has drawn more attention to the Indian financial system (Bapat, 2017). In addition, Indian banks have been operating in a hostile and competitive business climate for the past few years, which has forced them to allocate their resources efficiently (Viswanathan and others, 2014). Numerous research studies have been carried out to examine the effects of macro-economic (external determinants) and bank-specific (internal determinants) factors on the profitability of Indian banks (Al-Homaidi et al., 2018; Almaqtari et al., 2018; Bapat, 2017; Maiti & Jana, 2017; Almaqtari, Farhan, Thabit, & Al Homaidi, 2020; Seenaiah, Rath, & Samantaraya, 2015; Sinha & Sharma, 2016; Al-Homaidi, Almaqtari, Yahya, & Khaled, 2020). Using Return on

Equity (ROE) and Return on Assets (ROA) as indicators of banks' profitability, the bulk of these studies have looked at factors that influence profitability.

Therefore, the primary goal of this study is to evaluate the impact of country-level corporate governance on the profitability of Indian banks generally. To do this, we firstly investigate the issue while taking into account the different types of banks (public and private); secondly, we examine the influence of country corporate governance on the profitability of Indian banks in general.

The structure of the current paper is as follows: In Section 2, a few studies on bank profitability and corporate governance at the national level are introduced from the literature. The research design and methodology are presented in Section 3. The fourth Section includes an estimation and a discussion of the results. The study's conclusion, limitations, and suggestions are presented in the fifth section.

2. REVIEW OF LITERATURE

Country-level corporate governance is currently a major global problem for academicians, investors, regulators, and legislators. Since the 1990s, the term "Country-Level Good Governance" has gained acceptance in scholarly writings and grown in popularity (Ngobo & Fouda, 2012). The World Bank's country-level governance indicators are the most often utilized in research. Using the "Worldwide Governance Indicators of the World Bank" has two key benefits. The first is that they are widely used by many nations worldwide. This offers a fantastic chance to create intricate comparison models and a subset of these nations. The second benefit stems from its comprehensive strategy, which is formulated by integrating various perspectives from a multitude of businesses, citizens, and experts surveyed in both developed and developing nations. It is based on more than thirty distinct data sources that were created by various think tanks, survey institutes, non-governmental organizations, international organizations, and businesses in the private sector. "Aggregate and individual governance indicators for over 200 countries and territories over the period 1996 up to 2017" are reported in the World Bank's Worldwide Governance Indicators (The World Bank, 2019). Voice and accountability, political stability and violence-free politics, government efficacy, regulatory quality, the rule of law, and control are the six dimensions of assessment.

Robust government fosters a stable business climate and increased economic openness. It serves as an advocate for justice, market openness, legitimacy, and the sovereignty of the law. In addition, it provides a just framework for regulations, guarantees responsibility and transparency in business practices, and promotes healthy economic growth (Avram, Grosanu, & Rachisan, 2015). The majority of studies conducted in the subject of country-level governance agree on the significance of the governance's quality. They contend that social and economic progress are largely dependent on efficient national government (Rachisan, Bota-avram, & Grosanu, 2017). However, excellent governance at the national level has a significant impact on how compliant corporations and other business organizations are with national legal frameworks (Agyemang, Fantini, & Frimpong, 2015).

The framing of economic policies and a legitimate framework for corporate governance are necessary to guarantee steady economic growth as well as long-term, sustainable development. Nonetheless, a few international organizations began concentrating on how country-level governance contributed to their economic booms. Several eminent international organizations have stated that inadequate country-level governance is the reason behind the economic failure of several emerging nations (Ngobo & Fouda, 2012).

Studies evaluating the impact of corporate governance at the country level on profitability of banks, however, are scarce. Previous research looked into corporate governance at the country level from several angles. Some research, for instance, looked at corporate governance at the country level and how it relates to problems with finance, accounting, and auditing. There isn't enough research, to assess how corporate governance at the country level affects profitability. In the context of banks, Kamarudin et al. (Kamarudin et al., 2016) looked into corporate governance at the country level. According to (Khan, Al-Jabri, & Saif, 2019), a set of guidelines that support openness can be used to establish an efficient governance system. Regarding the MENA region, Sarhan et al. stated that accountability,

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corporate law, legal system, governance structure, highlight significant issues related to corporate governance in the context of banks.

There are dearth of studies measuring the impact of corporate governance at country level on the profitability of banks in India. Overall, this paper presents unique and novel evidence tying corporate governance quality with the profitability of banks. The Reserve Bank of India (RBI) published its biannual Financial Stability Report on June 30, 2017. According to the report, there has been a sharp increase in fraud and swindling, bad loans, extreme financial stress, and other problems in the financial sector. This in turn has an impact on the local banking industry's long-term viability (AlHomaidi et al., 2018; Viswanathan et al., 2014). These difficulties make it more interesting and necessary to investigate these problems.

3. RESEARCH GAP

Numerous studies have examined corporate governance at the national level in various jurisdictions across the world. There are, however, few studies that analyze the impact of corporate governance at the national level in India, which is an emerging economy. Further, a few variables have been studied in the Indian context, as a result, it fills a vacuum in the body of research on the profitability of Indian banks.

3.1 RESEARCH DESIGN

3.1.1 Variables

In this study, ROA, ROE and NIM are used to gauge a bank's profitability. These variables are extracted from RBI's official website. The Independent variables used in the study are Worldwide Governance Indicators including voice

and accountability, political stability and a lack of violence, the efficacy of the government, regulatory quality, the rule of law, and corruption control. A balanced panel data comprising of 33 Indian banks for a sample period from 2010 to 2022 is used.

3.1.2 Contribution

The results of the current study have a wide range of repercussions for many types of stakeholders, including regulators, politicians, bankers, analysts, and academicians. It may be possible to boost the profitability of Indian banks by enacting new regulations as well as a variety of policy actions. We urge that the regulatory authorities should carefully exercise their supervision powers in order to guarantee strict compliance, by the banking sector, to existing legislation on corporate governance.

The regression results of pooled OLS, fixed effect model and random effect model are highly significant. The R2 values showing the goodness of fit of the model. Most of the coefficients of the variables show expected sign as per theory. The Hausman test shows that random effect model is appropriate and it should be chosen over fixed effect model. Breusch-Pagan test concludes that random effect is appropriate therefore study has chosen random effect regression model. The results of Random effect regression are significant. The R2 value is 0.27. The variables are showing expected relationship.

But the data found heteroskedasticity and auto correlation among the data to remove this problem by using FGLS model.

4. ANALYSIS AND CONCLUSION

The regression results of pooled OLS, fixed effect model and random effect model are highly significant. The R2 values showing the goodness of fit of the model. Most of the coefficients of the variables show expected sign as per theory. The Hausman test shows that random effect model is appropriate and it should be chosen over fixed effect model. Breusch-Pagan test concludes that random effect is appropriate therefore study has chosen random effect regression model. The results of Random effect regression are significant. The R2 value is 0.27. The variables are showing expected relationship.

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But the data found heteroskedasticity and auto correlation among the data to remove this problem by using FGLS model.

5. CONCLUSION

This research aimed to examine the influence of country-level corporate governance on the profitability of Indian banks. The study utilized data from 12 public banks and 21 private banks in India between 2010 and 2022. The Worldwide Governance Indicators from the World Bank were employed to assess the governance dimensions during the same period. Profitability was measured using indicators such as return on assets (ROA), return on equity (ROE), and net interest margin (NIM), while country-level governance was evaluated through proxies including voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. The findings revealed a significant impact of country-level corporate governance on all profitability measures. However, political stability and voice and accountability demonstrated a positive and significant influence on the profitability of Indian banks. These findings provide valuable insights for policymakers, regulators, bankers, financial analysts, and academics in India, offering suggestions for policy and regulatory improvements to enhance the profitability of Indian banks. The study recommends promoting transparency, accountability, rule of law, regulatory quality, and control of corruption, as well as implementing efficient Basel III regulations. It proposes the oversight of governance practices by the Reserve Bank of India (RBI) and the establishment of a governance oversight body, in addition to conducting continuous risk assessments based on NPAs, capital adequacy, governance structure, and risk disclosures. The study contributes to the literature on country-level governance and banks' profitability, emphasizing the significance of governance dimensions for a conducive business environment and financial performance. Future research could update data, include additional variables, explore the profitability of Indian banks in relation to both country-level and bank-specific corporate governance, and conduct comparative studies across countries to assess the impact of country-level governance on sustainable profit generation.

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Appendix

Table 1 Comparison of Results of Regression Models Basis of ROA

Dependent Variable Trade Flow

Variables	Pooled OLS		Fixed effect		Random Effect		FGLS	
	Coefficients	**T**	**Coefficients**	**T**	**Coefficients**	**Z**	**Coefficients**	**Z**
Voice and Accountability	.669139	0.58	.669139	0.72	.669139	0.72	.669139	0.58
Political Stability no violence	-.646152	-1.85*	-.646152	-2.318*	-.646152	-2.318*	-.646152	-1.87**
Government effectiveness	-.5934572	-1.29*	-.5934572	-1.61	-.5934572	-1.61	-.5934572	-1.30
Rule of Law	-5.178019	-1.68*	-5.178019	-2.10*	-5.178019	-2.10*	-5.178019	-1.70**
Bank Dummy	.7288304	7.53			.7288304	3.32*	.7288304	7.60***
Demonetisation Effect	-.13479	-.50*	-.13479	-0.63	-.13479	-0.63	-.13479	-0.51
Constant	-.8722747	-1.19*	-.4255722	-0.73	-.4255722	-0.73	-.872247	-1.20

Source: Authors Own

Note: The test level of significant at 1%, 5%, 10% level that represent *, **, *** respectively. Two variables (Control of corruption and Regulatory Quality) show multicollinearity it is removed.

Overall R2	27%	
VIF	4.31	
X^2 for Hausman test	P. >0.05 = do not reject H0 it means random effect is appropriate	
$\overline{x}^2$ for BP test	P. < 0.05 it is concluded that random effect is more appropriate	

Table 2 Comparison of Results of Regression Models basis of ROE

Dependent Variable Trade Flow

Variables	Pooled OLS		Fixed effect		Random Effect		FGLS	
	Coefficients	**T**	**Coefficients**	**T**	**Coefficients**	**Z**	**Coefficients**	**Z**
Voice and Accountability	3.093229	0.20	3.093229	0.23	3.093229	0.23	3.093229	0.20
Political Stability no violence	-14.08839	-2.98*	-14.08839	-3.43*	-14.08839	-3.43*	-14.08839	-3.01*
Government effectiveness	-9.396749	-1.51*	-9.396749	-1.73*	-9.396749	-1.73*	-9.396749	-1.52
Rule of Law	-90.04197	-2.16*	-90.04197	-2.48*	-90.04197	-2.48*	-90.04197	-2.18*
Bank Dummy	7.154675	5.47*			7.154675	2.80*	7.154675	5.52*
Demonetisation Effect	-1.41082	-0.39	-1.41082	-0.45	-1.41082	-0.45	-1.41082	0.39
Constant	-15.96309	-1.61*	-11.57796	-1.35*	-15.96309	-1.81*	-15.96309	-1.63

Note: The test level of significant at 5% level that represent *. two variables (Control of corruption and Regulatory Quality) show multicollinearity it is removed.

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Overall R2	27%
VIF	4.31
X^2 for Hausman test	P. >0.05 = do not reject H0 it means random effect is appropriate
$\overline{x}^2$ for BP test	P. < 0.05 it is concluded that random effect is more appropriate

Table 3 Comparison of Results of Regression Models basis of NIM

Dependent Variable Trade Flow

Variables	Pooled OLS		Fixed effect		Random Effect		FGLS	
	Coefficients	T	Coefficients	T	Coefficients	Z	Coefficients	Z
Voice and Accountability	-.2388519	-0.31	-.2388519	-0.52	-.2388519	-0.52	-.2388519	-0.31
Political Stability no violence	-.3630854	-1.57*	-.3630854	-2.65*	-.3630854	-2.65*	-.3630854	-1.59*
Government effectiveness	.0584857	0.19	.0584857	0.32	.0584857	0.32	.0584857	0.19
Rule of Law	-3.692893	-1.81*	-3.692893	-3.05*	-3.692893	-3.05*	-3.692893	-1.83*
Bank Dummy	.7053326	11.03*			.7053326	3.78*	.7053326	11.13*
Demonetisation Effect	.1675837	0.95	.1675837	1.59*	.1675837	1.59*	.1675837	0.96
Constant	1.832965	3.79*	2.265266	7.91*	1.832965	5.71*	1.832965	3.83*

Source: Authors Own

Note: The test level of significant at 5% level that represent *. two variables (Control of corruption and Regulatory Quality) show multicollinearity it is removed.

Overall R2	27%
VIF	4.31
X^2 for Hausman test	P. >0.05 = do not reject H0 it means random effect is appropriate
$\overline{x}^2$ for BP test	P. < 0.05 it is concluded that random effect is more appropriate

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