

A Study on Corporate Governance Practices of Selected Banks in India

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Abstract

With the ever increasing complexity in the financial markets, the concept of corporate governance is carving a niche for itself. Off late, corporate governance has gained increasing attention from regulatory authorities and investors. Consistently over the past few years, regulatory changes have been made for governance practices in India and all over the world. Corporate governance ratings are being published for the ease of investment decisions, and corporate governance indexes are prepared by regulatory & non-regulatory agencies and researchers. In the present study, a corporate governance index for banks in India comprising of six sub-indexes was prepared and a comparison of selected public and private sector banks was done. Using the values of the index, the relation between corporate governance and banks' performance was ascertained using regression. It was found that corporate governance scores for private banks were greater than that of public sector banks, and when comparing the sub-indexes, private sector banks scored more in all of them, except risk management. A weak positive correlation was found between corporate governance and financial performance measured as ROA and NIM, and a significant correlation was found between corporate governance and PBV ratio.

Keywords: corporate governance, banks, corporate governance index, sub index, correlation

JEL Classification: G20, G30, G34

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Good corporate governance (CG) practices lead to public confidence in the activities of a company. One can get hints on the governance practices by referring the companies' corporate governance reports and CG Ratings and also the non mandatory practices followed (Gupta, 2015). Like credit ratings, the companies pursue ratings for their CG practices. Internationally, governance ratings are provided by commercial rating companies like ISS Quality Score, Risk Metrics, Governance International Metric, The Corporate Library, Audit Integrity, and SAHA, which are majorly based in developed countries like USA and UK. In India, corporate governance ratings are provided by few agencies, including ICRA, CRISIL, CARE, whose methodology of rating is over simplified when compared to the international rating agencies which use 200 and more variables to give CG ratings to the companies. With the growing business activities globally and increasing free market access, there is a need for Indian companies to sync in their corporate governance practices to the global best practices (Nachaal, 2008).

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Corporate governance of banks is more convoluted than it is for other industries for the reason that a bank sources funds from shareholders as well as its customers, and furthermore, banks have financial assets and liabilities on their balance sheets. Corporate governance can be important in providing stability and liquidity in difficult market conditions (Love & Rachinsky, 2015). Owing to the fact that the flow of activities in an economy largely depends on banks, they play an imperative task. The development of other industries is closely related to how authenticate the banking services are. Banks are the channels through which public funds are mobilized to the corporate world. Wide array of banking solutions are provided including procurement of funds, disbursement of funds, online transfers, bill discounting, letters of credit, merchant services, payroll services, cash management, and managing retirement accounts. A separate analysis of corporate governance of banks is required to really analyze the banking behaviour so that ways can be worked out to improve the corporate governance framework of banks (Himaj, 2014).

Theoretical Backdrop

Ararat, Black, and Yurtoglu (2017) used the Corporate Governance Index to study the corporate governance practices of Turkish public firms. The index was composed of sub - indexes representing board structure, board composition, disclosure, ownership, and shareholder rights. They used regression method to predict the relation of corporate governance on firms' profitability and market value and concluded that the principle sub - index that predicted higher profitability and market value was the disclosure sub - index.

Himaj (2014) found that there was better literature on how corporate governance effects risk - taking and performance. Cheung, Connelly, Liphapayom, and Zhou (2007) developed a Corporate Governance (CG) index based on OECD Principles of Corporate Governance and Code of Best Practices (HK Ex) and showed that a company's market value was positively related to the overall CG index. Majority of the questions in the index were in binary form (yes or no) and used regression analysis for their study. Venkataraman and Selvam (2014) argued that firms with more of government ownership created added opportunities and a better corporate governance framework leading to better financial results.

Rehmans and Mangla (2010) compared the financial performance of conventional and Islamic banks in terms of ROE and ROA. They studied the impact of macroeconomic variables and corporate governance variables on financial performance of sample banks by applying multiple regression models and concluded that corporate governance played a significant role in the financial performance of banks in Pakistan, irrespective of whether it was a conventional or Islamic bank. Bagchi (2011) argued that there were no abnormal returns on portfolios constructed on the basis of the corporate governance index. The index was made based on certain selected parameters and was given rating on a 10-point scale. Maroua (2015) studied the relationship between bank's stability and multi-stakeholders' governance and constructed Z - scores for this purpose. They concluded that members had a significant and negative impact on banks' performance. Fanta, Kemal, and Waka (2013) used multivariate regression analysis to examine the impact of corporate governance mechanisms in commercial banks to their performance in terms of ROE and ROA and found that there was a statistically negative effect of board size and audit committee on bank performance. Similarly, Goel, Bansal, and Sharma (2015) observed that when the board size increased, control was weakened and this resulted in hostile working capital management in firms. Love and Rachinsky (2015) argued that there was a significant but very moderate relation between corporate governance and banks' performance, and corporate governance at best had a second-order effect on performance.

Interestingly, on the contrary, Sarkar, Sarkar, and Sen (2012) found a strong association between corporate governance practices and market returns. They too made a corporate governance index with a 5-point scale using the important criterion like the board of directors, ownership structure, audit committee, and external auditors.

James and Joseph (2015) used regression analysis to study the influence of corporate governance on bank performance and found that among the variables studied, including ownership monitoring mechanism, board independence, and size, the corporate governance mechanism that significantly influenced bank performance was regulatory mechanism (capital adequacy ratio). Ștefănescu (2011) found that shareholders' concentration and board size had no influence on the performance of banks. A positive correlation was established between traditional strategies of banks, corporate governance, and banks' performance.

Tyagi, Atif, and Naseem (2013) made a comparative study of corporate governance practices of public and private sector banks using content analysis and established that the private banks had better corporate governance when compared to public sector banks.

Research Gap

From the above literature review, it can be understood that there is a mixed opinion about CG having an impact on financial performance of companies. The extent of literature on banking is very limited and much of the research relates to outside India and moreover, CG Indexes for studying banks are also seldom used. This study makes an attempt to find the correlation of banks' CG practices with financial performance using a corporate governance index, especially for banks.

Objectives of the Study

- ↳ To study the corporate governance practices of selected banks in India by preparing the Corporate Governance Index (CGI).
- ↳ To make a comparative study of corporate governance practices of the selected public sector and private sector banks.
- ↳ To find any relation between corporate governance practices and financial performance of the banks.

Methodology and Data

To study the corporate governance practices of banks, the corporate governance (CG) index has been prepared covering 39 criteria divided into six sub indexes. The sub - indexes are board of directors, audit committee, remuneration committee, nomination committee, risk management, and disclosures. Each criterion was given a score of 1 if the bank complied with the practice and 0 if not. Few criteria were assigned a negative score if the bank exceeded such a limit. The maximum score any bank could earn is 34.

The index has been prepared keeping in view the Clause 49 of Listing Agreement of SEBI ; Companies Act, 2013 ; and OECD Principles on Corporate Governance Practices. A wide range of corporate governance practices are included in the index that are of utmost importance for proper functioning of banks. The index covers criteria on independence of board, the committees on board, risk management in banks, and level of disclosures. The study is done for one year, and the data were collected through content analysis of annual reports of the year 2016 and corporate governance reports of the banks. Ten banks are included in the study - five public sector and five private sector banks. The five public sector banks were selected on the basis of Corporate Governance Rating given by ICRA and CARE. Five private sector banks were selected on the basis of market capitalization. For this purpose, five private sector banks from BANKEX of BSE India with highest market capitalization were selected. The following banks are included in the study :

Public Sector Banks :

- ↵ Andhra Bank (CGR 2 by ICRA),
- ↵ Bank of Baroda (CGR 2 by ICRA),
- ↵ Bank of India (CGR 2 by ICRA),
- ↵ Central Bank of India (CGR 3+ by ICRA),
- ↵ Punjab National Bank (CGR 2 by CARE).

Private Sector Banks :

- ↵ Axis Bank
- ↵ HDFC Bank
- ↵ Kotak Mahindra Bank
- ↵ ICICI Bank
- ↵ IndusInd Bank

After the corporate governance scores were finalized for the purpose of studying the relation of corporate governance with the performance of banks, regression analysis (Cheung et al., 2007; Fanta et al., 2013) was done in Eviews software. The performance of the banks was measured in terms of return on assets (ROA), net interest margin (NIM), and price-to-book value ratio (PBV). ROA, NIM, and PBV are popular measures used by the investors to study the financial progress of firms. The regression model is given by :

$$\begin{aligned} ROA &= \beta_1 + \beta_2 X_1 + \beta_2 X_2 \dots + \beta_7 X_6 + \mu_i \\ NIM &= \beta_1 + \beta_2 X_1 + \beta_2 X_2 \dots + \beta_7 X_6 + \mu_i \\ PBV &= \beta_1 + \beta_2 X_1 + \beta_2 X_2 \dots + \beta_7 X_6 + \mu_i \end{aligned}$$

The dependent variables given by RAO, NIM, and PBV represent the financial performance of the banks. ROA and NIM indicate the accounting performance and PBV ratio is the market related variable. The independent variables are the corporate governance score of each sub - index. In the above formula, β_1 stands for intercept, $\beta_2 X_1$ is the regression coefficient for independent variable one, $\beta_2 X_2 \dots + \beta_7 X_6$ stand for regression coefficient for independent variables two to six, and μ_i is the error term.

Analysis and Results

The Table 1 shows scoring of each public sector and private sector bank on the corporate governance practices. The maximum total score is 29, earned by HDFC Bank and the least score is 15, earned by Bank of India. The total score of private sector banks is greater than that of public sector banks. It can be noted that few criteria like minimum number of board meetings, remuneration committee, risk management plan, and disclosures are assigned points for all the banks, which means these practices are followed by both public sector and private sector banks. Interestingly, it can be observed that the proportion of independent directors in all the sample public sector banks is less than 50%, which may be because of the appointment of other nominee and government directors on the boards of public sector banks. All the public sector banks scored a -1 for the criteria of number of meetings exceeding 11, and all the private banks scored 0 for the same. Only ICICI Bank had an independent director

Table 1. Corporate Governance Index for Selected Banks in India

Criteria	Point	Andhra Bank	Bank of Baroda	Bank of India	Central Bank	Punjab National Bank	Axis Bank	HDFC Bank	Kotak Mahindra Bank	ICICI Bank	IndusInd Bank	
		Public Sector Banks				Private Sector Banks						
BOD												
Board consists of not more than 12 members (-1).	-1 or 0	0	0	0	0	-1	-1	0	0	-1	0	
Chairman of the Board is independent or non-executive.	1 or 0	0	1	1	0	0	0	1	1	1	1	
Proportion of independent directors is equal to or more than 50%.	1 or 0	0	0	0	0	0	1	1	0	1	1	
CEO and Chairman are separate.	1 or 0	0	1	1	1	1	1	1	1	1	1	
Minimum 4 board meetings are held.	1 or 0	1	1	1	1	1	1	1	1	1	1	
Maximum number of meetings do not exceed 11 (-1).	-1 or 0	-1	-1	-1	-1	-1	0	0	0	0	0	
Declassified board.	1 or 0	0	0	0	0	0	0	0	0	0	0	
Independent directors are trained.	1 or 0	1	1	1	1	1	1	1	1	1	1	
Independent directors meet separately.	1 or 0	1	0	1	0	1	1	1	1	0	1	
Independent director serving more than 8 years on the board (-1).	-1 or 0	0	0	0	0	0	0	0	0	-1	0	
Appointment of lead independent director.	1 or 0	0	0	0	0	0	0	0	0	0	0	
Multiple directorship in more than 7 companies (-1).	-1 or 0	0	0	0	0	-1	0	-1	0	-1	-1	
TOTAL SCORE FOR BOD		2	3	4	2	1	4	5	5	2	5	
AUDIT COMMITTEE												
Chairman of audit committee is independent.	1 or 0	1	1	1	1	0	1	1	1	1	1	
Minimum of 2/3rd directors are independent.	1 or 0	0	0	0	0	0	1	1	1	1	1	
Meets atleast 4 times a year.	1 or 0	1	1	1	1	1	1	1	1	1	1	
Independent members meet separately.	1 or 0	0	0	0	0	0	1	1	0	0	1	
External auditor provides only audit services.	1 or 0	1	1	1	1	1	0	1	0	0	0	
Internal auditors report directly to audit committee.	1 or 0	1	0	0	1	1	0	1	1	0	1	
TOTAL FOR AUDIT COMMITTEE		4	3	3	4	3	4	6	4	3	5	
REMUNERATION COMMITTEE												
Remuneration committee exists.	1 or 0	1	1	1	1	1	1	1	1	1	1	

All are non-executive members.	1 or 0	1	1	0	1	1	1	1	1	1	1
Chairman is independent.	1 or 0	0	0	0	0	0	1	1	1	1	1
Meets at least 2 times a year.	1 or 0	0	1	0	1	1	1	1	1	1	1
Performance evaluation of independent directors.	1 or 0	1	0	0	0	0	1	1	1	1	1
Performance based incentive to CEO.	1 or 0	1	1	0	1	1	1	1	1	1	1
TOTAL FOR REMUNERATION COMMITTEE		4	4	1	4	4	6	6	6	6	6

NOMINATION COMMITTEE

Nomination committee exists.	1 or 0	1	1	1	0	1	1	1	1	1	1
2/3rd are independent.	1 or 0	0	0	0	0	0	1	1	1	1	1
Chairman is independent.	1 or 0	0	0	0	0	0	1	1	1	1	1
Meets at least two times in a year.	1 or 0	0	1	0	0	1	1	1	1	1	1
TOTAL OF NOMINATION COMMITTEE		1	2	1	0	2	4	4	4	4	4

RISK MANAGEMENT

RM plan exists.	1 or 0	1	1	1	1	1	1	1	1	1	1
Single borrower limit has not been exceeded (-1).	-1 or 0	0	0	0	0	0	0	0	0	-1	-1
Credit allocation procedure exists.	1 or 0	1	1	1	1	1	1	1	1	1	1
Prior approval of audit committee required for RPTs.	1 or 0	1	0	0	1	0	1	0	0	0	0
Approval of shareholders by a special resolution for divestment of material subsidiary.	1 or 0	0	1	0	1	1	1	1	0	1	0
TOTAL OF RISK MANAGEMENT		3	3	2	4	3	4	3	2	2	1

DISCLOSURES

RPTs disclosed	1 or 0	1	1	1	1	1	1	1	1	1	1
Any non-compliance and penalties and strictures thereto.	1 or 0	1	1	1	1	1	1	1	1	1	1
Ratio of remuneration of each director to the median of employees' remuneration.	1 or 0	0	0	0	0	0	0	1	1	1	1
Succession plan	1 or 0	0	0	0	0	0	0	0	0	0	0
Criteria for remuneration to non executive directors disclosed.	1 or 0	1	1	1	1	1	1	1	1	1	1
Whistle blowing policy exists.	1 or 0	1	1	1	1	1	1	1	1	1	1
TOTAL OF DISCLOSURES		4	4	4	4	4	4	5	5	5	5
TOTAL MAXIMUM SCORE		34	18	19	15	18	17	26	29	26	22

serving more than 8 years on the board ; such a director may not be considered independent due to such a long association with the bank. Directors of majority of the private sector banks were having multiple directorships in more than seven companies. The chairman of audit committee of Punjab National bank was not independent and all other sample banks had an independent chairman for audit committee ; Central Bank of India did not have a nomination committee on its board. None of the sample banks had a succession plan for the appointment of directors.

Table 2. Sub - Index Scores for the Selected Banks in India

Sub - Index Criteria	Total Score of Public Sector Banks	Total Score of Private Sector Banks
BOD	12	21
Audit Committee	17	22
Remuneration Committee	17	30
Nomination Committee	6	20
Risk Management	15	12
Disclosures	20	24

The Table 2 shows the scoring of public and private banks on each of the sub - indexes. Comparatively, on majority of the sub - indexes, the scores of private banks are more than that of public banks. Only on one sub - index, risk management, the score of public sector banks is greater than that of private banks. The public banks scored less on director's independence and remuneration committee and nomination committee. The total score of nomination committee for public banks is very less when compared to private sector banks as Central bank of India did have the committee in place. The risk management score of public sector banks is greater than that of private sector banks, indicating that though the other corporate governance practices are not in place, but the public sector banks have better risk management than the private sector banks.

(1) Descriptive Statistics : The Table 3 shows the descriptive statistics of the dependent variable (NIM, PBV, and ROA) and the six sub - indexes. The minimum and maximum of disclosures is 4 and 5, respectively and the mean of it is 4.40, which indicates an apparently higher average. Though the minimum of remuneration committee is 0 and maximum is 4, the mean is 2.6, which hints that the banks which have points for this sub - index have scored higher scores. Three out of the six sub - indexes have 1 as the minimum, audit committee has 3, disclosures has 4, and only nomination committee has 0 as the minimum. Comparatively, audit committee and BOD have a lesser mean.

The following are the abbreviations used in the analysis for variables :

- X1 = Audit committee,
- X2 = Remuneration committee,
- X3 = Nomination committee,
- X4 = Risk management,
- X5 = Disclosures,
- X6 = BOD,
- D (ROA) = first differenced ROA.

The Table 3 shows descriptive statistics for financial variables too. Only ROA has a negative minimum of -0.0094. PBV ratio has a minimum value of 0.35 and maximum value of 3.85, showing a wide range and the

Table 3. Descriptive Statistics

	<i>NIM</i>	<i>PBV</i>	<i>ROA</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>X6</i>
Mean	0.034	1.76	0.0082	3.9	4.70	2.60	2.70	4.40	3.30
Median	0.033	1.312	0.0147	4.00	5.00	3.00	3.00	4.00	3.50
Maximum	0.044	3.85	0.019	6.00	6.00	4.00	4.00	5.00	5.00
Minimum	0.021	0.35	-0.0094	3.00	1.00	0.00	1.00	4.00	1.00
Std. Dev.	0.0074	1.40	0.012	0.99	1.64	1.58	0.95	0.52	1.49
Jarque-Bera	0.52	1.19	1.38	1.39	2.11	1.095	0.29	1.68	0.91
Probability	0.77	0.55	0.50	0.49	0.345	0.58	0.86	0.43	0.63
<i>N</i>	10	10	10	10	10	10	10	10	10

mean *PBV* ratio is 1.76. The minimum and maximum values for *NIM* are 0.021 and 0.044, respectively and the mean *NIM* is 0.034. The Jarque - Bera probability for all the variables is above 0.05, so the data is normally distributed (Thadewald & Büning, 2007).

(2) Regression Analysis : Least square regression model was used for the analysis. Several regressions were run to get the correlation coefficient between the independent and the dependent variables. First differencing was used to arrive at the final result of the tests.

The Table 4 shows the correlation between the three independent variables and it can be observed that *ROA* and *NIM* exhibit the highest correlation coefficient at 0.8911, both being accounting - related variables. The correlation of *ROA* with *PBV* is the least at 0.6923, *PBV* being the market-related variable. The Table 5 shows the regression coefficients for independent variables and the dependent variables, that is, *ROA*, *NIM*, and *PBV*. The final output of the test shows significant relation of *ROA* with the sub - indexes of audit committee, nomination committee, and *BOD*. There is a negative correlation of - 0.004006 between *ROA* and *BOD* score. The normal distribution of residuals results in Jarque - Bera probability of 0.7872. There is no serial correlation between the residuals as the Breusch - Pagan test results in probability of 0.329, as p - value > 0.05. The residuals are homoskedastic because the probability value in the test for heteroskedasticity is 0.6786 (p > 0.05, which implies homoskedasticity (Breusch & Pagan, 1979)) and there is no autocorrelation between the residuals as the probability values are more than 0.05 (Andrews, 1991). There is no problem of multicollinearity between the independent variables. R^2 is at 0.875694, indicating that 87% of the variation in *ROA* can be explained by the corporate governance variables studied here.

The tests run results in significant coefficient between *NIM* and audit committee, nomination committee, and risk management scores. All have shown positive relation. The normal distribution of residuals results in Jarque - Bera probability of 0.8045. There is no serial correlation between the residuals as the Breusch - Pagan test results in probability of 0.0752. The residuals are homoskedastic because the probability value in the test for

Table 4. Correlation Between all Dependent Variables

	<i>ROA</i>	<i>NIM</i>	<i>PBV</i>
<i>ROA</i>	1		
<i>NIM</i>	0.8911	1	
<i>PBV</i>	0.6923	0.8643	1

Table 5. Coefficients for the Dependent and Independent Variables

Dependent Variable→			
Independent Variable↓	<i>ROA</i>	<i>NIM</i>	<i>PBV</i>
X1	0.005268**	0.003795**	
X2			0.343799***
X3	0.007114***	0.004202***	
X4		0.002686***	
X5			0.708374***
X6	-0.004006***		0.506964***
R^2	0.875694	0.821232	0.953
F - statistic	14.08938		
Prob (F-statistic)	0.004001		

Note. **Significant at 10% significance level ; and ***Significant at 5% significance level

heteroskedasticity is 0.8261, and there is no autocorrelation between the residuals as the probability values are more than 0.05. There is no problem of multicollinearity between the independent variables. The R^2 here has shown that 82% of variation in the NIM variable can be explained by the corporate governance variables studied here.

Several tests that were run result in a positive relation between PBV ratio and remuneration committee, disclosures, and BOD scores. The highest coefficient being that with disclosure practices. The normal distribution of residuals results in Jarque - Bera probability of 0.6279. There is no serial correlation between the residuals as the Breusch - Pagan test results in probability of 0.1627. The residuals are homoskedastic because the probability value in the test for heteroskedasticity is 0.1250, and there is no autocorrelation between the residuals as the probability values are more than 0.05. There is no problem of multicollinearity between the independent variables. The R^2 indicates that 95% of variation in PBV ratio is explained by the corporate governance variables studied here.

Conclusion

Corporate governance is a qualitative study which is difficult to assess in quantitative terms. An attempt has been made to show the corporate governance practices of public and private sector banks with the help of a corporate governance index in this study. The governance index score of private sector banks is more when compared to public sector banks, except for risk management. The study reveals that private banks have inculcated the corporate governance practices better than the public sector banks because the public sector banks are restricted by the Banking Regulations Act, RBI guidelines, and government policies and have to take decisions accordingly. There is a positive correlation of corporate governance sub indexes with the PBV ratio and highest correlation of PBV ratio with the disclosure practices, which is in similar lines to the results of study made by Ararat et al. (2017). The remaining two financial variables : ROA and NIM show statistically not so significant correlation with the corporate governance sub - indexes. PBV is a market related variable for measuring of financial performance and ROA and NIM are accounting related variables. So, it can be inferred that governance practices of banks are being observed by the market investors and do influence the market performance of banks.

Research Implications

This study highlights an array of corporate governance practices followed by selected banks in India. The research also points towards positive correlation between the CG practices and financial outcome of these banks. The findings of our study have implications for both the banks and investors. Banks have to understand that their governance practices impact financial results and can identify the CG practices which are highly correlated with financial performances and can take measures to keep improving such practices.

The information can also be used by investors in knowing the major CG practices of banks shown at a single point. The CG Index Score can act as a guide to know the bank that best follows these practices, and sub - indexes can be studied for details on CG practices of selected banks and also for comparison between banks. The public sector and private sector banks can get lessons from each other on best CG practices, which may help them to understand where they need to improve.

Limitations of the Study and Scope for Future Research

The scope of the present study is restricted to 10 banks. Future studies can consider a larger sample size to get a broader view of the scenario. The study uses one - year data only. If the study period can be extended, it could provide more in-depth information to improve the accuracy of the results. The governance of banks is a less explored area, and the study can provide guidance for further research on corporate governance practices of banks by adding more criteria to the index.

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