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DRG Study No. 47: Governance, Efficiency and Soundness of Indian Banks

The Reserve Bank of India today released on its website the DRG Study* titled, "*Governance, Efficiency and Soundness of Indian Banks*". The study is co-authored by Rachita Gulati, Sunil Kumar, S. Chinngaihlian, Rajendra Raghumanda and Prabal Bilantu.

This study adopts a granular research approach and empirically explores the nexus between governance, efficiency and soundness in the Indian banking industry at various disaggregation levels using the dynamic panel data models. Bank-wise composite indices of governance and soundness are computed using the non-parametric "Benefit-of-the-Doubt" approach, and the risk-adjusted profit efficiency scores for banks are estimated by employing the data envelopment analysis approach. The analysis has been completed utilising a unique bank-level panel dataset obtained from publicly available information on corporate governance in the individual bank's annual report for the period from 2008-09 to 2017-18. The key findings from the study are as follows:

i) Although banks in India have made significant progress in adhering to governance standards over the recent years, the current level of compliance is not adequate to mark the existing governance structure as "socially efficient".

ii) The Indian banking industry remained reasonably sound from 2008-09 to 2012-13, before the early signs of a decline in asset quality and profitability were observed in 2013-14. In recent years, private banks have by and large shown an improvement in their soundness position. However, a low level of soundness remains a challenge for public sector banks (PSBs) because the above trend was more pervasive for PSBs.

iii) There exist noticeable asymmetries in the policy priorities of banks on the dimensions of governance and soundness. Private banks demonstrated relatively better performance in adhering to governance norms pertaining to audit function, followed by risk management and board effectiveness during the study period.

iv) Profit-efficient banks are sufficiently sound to keep up capital buffers and absorb shocks, which may diminish destabilising effects. Therefore, to avoid the risk of bank failure in the long run, business practices that assure sustainable profits with proportionate risk need to be encouraged.

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*: Development Research Group (DRG) has been constituted in Reserve Bank of India in its Department of Economic and Policy Research to undertake quick and effective policy-oriented research backed by strong analytical and empirical basis, on subjects of current interest. The DRG studies are the outcome of collaborative efforts between experts from outside Reserve Bank of India and the pool of research talent within the Bank. These studies are released for wider circulation with a view to generating constructive discussion among the professional economists and policy makers. DRG studies are published on RBI website only and no printed copies will be made available.

v) Econometric findings from the study reveal that the degree of governance compliance in banks significantly explains their soundness level. Non-adherence to governance principles can undermine the soundness of the banking system.

vi) An emphasis only on stringent compliance with board attributes without due attention to other important aspects of governance, including risk management and audit functions, can have implications for bank soundness. In all, the study reveals that traditional equity governance principles not only determine bank soundness in India, but compliance with debt governance standards also assumes an important role in determining bank soundness, particularly in the aftermath of 2014.

(Yogesh Dayal)
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