

Press Release

IIMA Misra Centre for FME undertook[[1]](#footnote-1) a study “Profit Efficiency and Corporate Governance of Indian Banks”

**October 27, 2020 | Ahmedabad:**

**SUMMARY:**

Traditionally banks are highly regulated entities given their systemic impact on the real sector. Therefore, understanding their performance is critically important. In this context, this paper examines the impact of board structure on the profit efficiency of Indian banks. After estimating profit efficiency using a directional distance function methodology that account for undesirable output, the study decomposed the profit inefficiency into technical and allocative inefficiency to disentangle the source of the inefficiency over ownership pattern. On an average, it was observed that the performance of public sector banks (state-owned) has been relatively poor due to their high levels of profit inefficiency emanating primarily from allocative inefficiency. While explaining this efficiency differential, it is observed that board composition and structure plays an important role. Indian banks with larger boards and those that pay higher sitting fees to the members exhibit better performance. Among the private sector banks, the key corporate governance variables that improve the performance include higher proportion of female board members and relatively larger proportion of independent board members. This study contributes to the debate on the role of board structure in bank performance.

The full report is available along with other working papers on Misra Centre on Financial Markets and Economy (MCFME) page: <https://www.iima.ac.in/web/areas-and-centres/research-centres/misra-centre-for-financial-markets-and-economy/research-and-publications>

**KEY INSIGHTS/FINDINGS FROM THE STUDY:**

Even after deregulation of Indian financial sector initiated during 1991-92, state-ownership continues to dominate the banking sector. Dual control of regulatory structure of PSBs has been one of the biggest bottlenecks to streamline their corporate governance structure. Performance of PSBs has been a cause of concern for Indian policy makers. For an emerging market country with a bank-based financing structure, higher inefficiency of banks potentially hinders the growth potential. A sizeable part of the inefficiency is allocative in nature, implying the effect of misallocation of resources into productive business opportunities. This has resulted in higher non-performing loans of PSBs. In this context, the role of corporate governance is critical.

Empirical results suggest that board size matters, providing yet another support of agency and re- source dependency theory of corporate finance. That is, more board members do exert pressure for bank performance by better monitoring and control. At the same time, they bring wide variety of expertise which are performance enhancing. The study also finds that better performance is associated with higher compensation. High-powered incentives might motivate the board members to actively contribute in the monitoring and advisory roles. Findings on the influence of independent board members on bank performance suggest that the private banks benefit from a higher proportion of such members. Finally, the study concludes that there is a weak association between diversity and bank performance. Private sector banks tend to benefit from the presence of female board members and board members with high network potential.

A healthy banking system is essential for a country to facilitate an efficient allocation of credit to the real sector. In a country with a high proportion of government owned banks, it is imperative for the policy makers to provide a conducive environment for the efficient functioning of the bank boards. Empowering the boards can lead to a stronger governance structure that will facilitate better risk management and an efficient allocation of resources.

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1. *The report was prepared by Prof. Abhiman Das of IIMA and Prof. Balagopal Gopalakrishnan of IIMK* . [↑](#footnote-ref-1)