# Ownership Structure, Regulation and Corporate Governance: A study of Private Banking in India during 2002-2008.


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Abstract

In the backdrop of the understanding that corporate governance in banks is more complicated than firms, this study examines the implications of certain regulations for corporate governance of private banking industry in India. It also analyses the factors that have a bearing on the evolution of the regulatory framework. The study argues that the policy of restrictions of voting rights has not achieved its objectives and has led to a conflict between the bank and regulator. Furthermore, it points towards new dimensions of corporate governance which underlines the vulnerability of the depositor as a major stakeholder of banks.

We have a five stage methodology including generalized estimating equation, Discriminant analysis and an innovative corporate governance identification matrix that throws light on a new type of conflict in corporate governance. The paper has with the help of a t-test shown that vulnerability of depositors is much higher in the case of old banks. In addition, the study shows that closely held banks have extremely high deposits to equity ratio. Hence, old banks in general and closely held banks in particular need to be treated differently from closely held firms for corporate governance reasons. Finally it concludes that corporate governance abuses in private banks poses a very difficult regulatory dilemma.

Key words: bank, corporate governance, ownership structure, government policy, corporate voting.

JEL codes: G21, J30, J32, J38, J34.

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## Introduction

The entry of private banks in banking industry subsequent to deregulation has brought to the fore certain issues of corporate governance. Most of the studies on banking in recent time have viewed deregulation and its impact on banking in terms of efficiency. It would be pertinent to point out that the peculiarity of banks lies in their dual objective function which equally emphasizes the need for liquidity and hence stability. The present study highlights it problems relating to instability, run and even closure, all of which can not be explained merely in terms of issues of production and efficiency. While entry of private banks was allowed in order to improve the functioning of the public sector banks through competition, it is public sector banks which had to rescue the failed private sector banks[1]. Many of the issues in corporate governance in banks escaped attention of the researchers even when there was a very large scale diversion of funds from banking system to brokers for financing their operations in the stock market, in 1992. While the stock market scam involved a large number of nationalized and foreign banks, it led to closure of a private bank called bank of Karad. The objective of this paper is to shift the focus in banking research from efficiency based issues to ownership based issues. Moreover,

[1] Global Trust Bank and Nedangudi Banks were merged into Oriental Bank of Commerce and Punjab National Bank respectively

banking industry as such has an essential of regulation in the form of the central bank inspired of the introduction of deregulated environment. This paper therefore seeks to examine the relationship between ownership structure, regulation and corporate governance in private banking industry in India.

The structure of the paper is as follows:

Section II lays out a brief review of literature. Section III provides a conceptual framework of corporate governance and argues that corporate governance in banks is more complicated than firms. Section IV analyses the evolving legal framework with special reference to minimum paid up share capital, shareholding by promoter and voting rights and attempts to explore their implications for ownership governance issues in private banks in India. In Section V we have the background of the study. It also contains the methodology the hypotheses of the study. Section VI analyses the results of the study. Section VII provides the summary and conclusion.

**Section II: Review of literature**

The extant literature on banking in India concentrates on issues of production and efficiency (De,2004; Das,1997;Agarwal,1991)A small but different set of studies looks into industrial organization approach to banking (Deb,2005; Murthy and Deb,2008; Murthy and Deb,2008a; Murthy and Deb, 2009) However, neither of these trends in literature open up issues relating to ownership and corporate governance.

Issues of ownership in banking literature have essentially arisen from the point of view of private versus public sector. One such study by Sarkar, Sarkar and Bhawmik (1998) talks about ownership, but relates it to performance rather than governance. An implicit assumption made by scholars (Singh, 2002 and Bhaumik, 2005) arguing in favour of

privatization of public sector banks relate to poor corporate governance in public sector banks. If the reason behind unsatisfactory performance of the public sector banks lies is poor corporate governance, than privatization of public sector banks will not deliver the goods if the corporate governance in private sector banks is not significantly better than their public sector counterparts. The whole debate relating to privatization of public sector banks appears to be devoid of any reference to corporate governance in banks. In fact, the issue is misplaced in as much as the debate veers towards privatization, in light of poor performance of public sector banks, instead of emphasizing good corporate governance.

Reddy (2002) doubts whether corporate governance is generally better in private sector banks. A few old private sector banks continue to be closely held and many of them resist broadening their shareholder base and thus avoid deepening of corporate structures. More often than not, takeover bids have been by equally closely held groups. Promoters were expected to dilute their stakes in new private sector banks to below 40 per cent within three years. It is yet to be fully complied with in all the private banks. In most cases, the banks continue to be identified with effective controlled by promoter institutions. According to Jalan (2002), old private sector banks also have very poor auditing and accounting systems. New private banks are generally good on accounting, but poor on accountability. They are more modern and computerized, but less risk conscious[2]. It may be added here that their exposure to off-balance sheet activities is extremely high, second to only foreign banks. A phenomenon common to all private banks is that corporate governance is highly centralized with very little real check on the CEO, who remains also

[2] Their exposure to off-balance sheet activities is extremely high, second to only foreign banks.

closely linked to the largest owner groups[3]. He goes to state that their boards or auditing systems are not very effective.

**Section III: Corporate governance in banks: A conceptual framework**

Schumpeter christened banks to be the gatekeeper of the economy. In more recent times an ordinary definition of corporate governance has been:

> "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their Investment".
>
> (Shleifer, A. and R.W. Vishny; 1997)

This is based on the separation of ownership and control and investigates into the mechanisms through which suppliers of capital diffuse and concentrated debt and equity holders influence managerial decisions with varying degrees with success. However, this is an extremely narrow concept, which covers only one conflict: conflict between owner, who owns but does not manage and managers, who manages but does not own the firm. Murthy (2008) argues through an economic interpretation of corporate governance in banks that the role of banks is efficient allocation of investible funds in the economy. It however recognizes the presence of instability and conflicts...

The present study study draws from the concept of corporate governance, which seeks to explicitly interpret the phenomenon in terms of a number of conflicts (Murthy, 2008).The study analyses five distinct conflicts. The most well known among them relates to conflict between managers and shareholders. Managers are not perfect agents of risk preferring shareholders. While shareholders want profit through risk taking, managers

[3] An instruction from RBI to separate the posts of CEO and MD in an attempt to bring about decentralization led to threat of resignation by the chief of a new private bank, (Business Line, April 23, 2009)

would be interested in growth of the firm, which will provide them more power and perks. The second conflict occurs when majority shareholders seek to exclude minority shareholders from strategic decision making. The third conflict involves majority shareholders for control of the firm. The next conflict arises between share holders and fixed claimant holders because risk increasing investment strategy is at the cost of fixed claimant holders. While the above interpretation of corporate governance provides a very useful conceptual framework to highlight the differences between corporate governance in banks from firms, the current study attempts to include another conflict to the list of conflicts already provided by Murthy (2008). It introduces tussle between majority owners for control as another conflict relating to corporate governance. It has been explained later, how this conflict is a product of conflict between promoters and regulators in private banking industry in recent times.

It is argued that corporate governance in a bank involves more conflicts compared to a firm, because of existence of differences between a firm and bank. Unlike other firms, banks do not have major equity capital. In case of a bank, a major part of the responsibility is not on account of equity, but on account of having an overwhelming liability in the form of deposits. This imposes a certain responsibility and accountability, which means that banks must be responsible and accountable to the depositors in numerous aspects including deployment of the funds, risk profile of such deployment, spread management and so on. A conflict arises between the owners i.e. shareholders, who want to maximize profitability by undertaking risks and depositors, for whom the safety of their deposits is the prime concern. Depositors do not want high return like shareholders and yet they are adversely impacted because of risk taking by equity holders

beyond prudent limits. Unlike debt and equity, deposit have no role in corporate governance in bank  In a world without deposit insurance, risk averse depositors, would demand that banks refrain from engaging in risky investments strategies. Deposit insurance protects the funds of the depositors with the banks regardless of the outcomes of the investment strategies selected by the banks.

However, it may be argued that deposit insurance leads to a reduction in the normal levels of monitoring within the firm. The level of protection afforded by the deposit insurance removes any incentive for insured depositors to control excessive risk taking, it also removes their incentive to monitor in order to reduce the incidence of fraud and self-dealing.  Shareholders have an incentive to monitor to prevent fraud and self-dealing in banks, but such monitoring is notoriously ineffective in many cases because individual shareholders rarely have sufficient incentives to engage in monitoring because of collective action problems. Outside the banking setting, fraud and self-dealing are monitored by fixed claimants and preferred shareholders through contractual devices and by lenders through oversight of their borrowers' affairs. Deposit insurance schemes reduce the incentives of depositors to monitor banks, induce banks to rely less on unsecured creditors, and along with the rise of central banks as lender of last resort have contributed to create banks with low capital-asset ratio. Such factors have increased the incentives for bank owners to increase.

Another issue complicating   the issue of corporate governance in banks relate to regulation by the central bank for prudential and monetary policy purposes. Banks engage in a very risky business of lending money which does not belong to them. Competition adds to the risk as they have to survive on squeezed spread. This led to the

regulators to fix prudential norms relating to capitalization, capital adequacy, income recognition and asset classification etc. Some of these norms may bring the shareholders of banks in conflict directly with the regulator. For example, while central bank wants the shareholders to bring additional capital so that they fulfill the norms of capitalization, shareholders will resent it as it will dilute their control over the bank. For monetary policy purposes central banks change cash reserve ratio and statutory reserve ratios of banks and banks transmit the monetary policy stimulus to the economy. A rise in the cash reserve ratio and statutory reserve ratios eat into the profits of the bank and hence go against the interest of the shareholders. Presence of additional conflicts between regulator and shareholders one the one hand and shareholders and depositor on the other hand has rendered the issue of corporate governance in banks more complicated than an ordinary firm Interestingly attempts to align the interests of depositor with the . Shareholder through deposit insurance lead to a rise in the incentive of the shareholder to take more risk makes the issue even more complicated.

**Section IV: Regulatory issues.**

The impact of ownership structure on governance structure is mediated through legal provisions evolving through time. The major regulations relating to ownership include minimum paid up equity capital, voting rights and promoter shareholding. These regulations and their evolution over time deserve scrutiny before analyzing their implications for private banks.

***Minimum paid up share capital***

As per new regulations introduced in 1993, private banks are required to adhere to a

minimum paid up share capital of Rs. 1 billion. However, the current stipulation of Rs 1 billion is considered to be too low due the following reasons. They include inability to cope up in competitive environment with a low equity base, deterrence to non-serious players, mergers between private banks, intention of foreign banks to acquire local banks and lastly, need of frequent bouts of capital infusion with small size of balance sheet. A large equity is expected to go along with a broad based ownership and better corporate governance. However, with the presence of a strong domestic lobby, working against any move to impose a very stiff stipulation about minimum paid up share capital, the regulation was toned down and minimum paid up share capital was raised to Rs. 200 in January 2001. However, RBI, in the draft released in July 2004, proposed the minimum capital for banks, be scaled up to Rs 300 crore within three years. RBI has added that some private banks, set up before January 2001, have not yet been unable to raise their capital even to Rs 200 crore. Such stiff stipulation by RBI did not find favor with the Finance Ministry. It was argued that the proposed level of capital is too high for start-ups to come up in the banking sector and hence would stifle competition in banking industry. The Ministry felt that making the norms applicable to the existing banks would result in large-scale upheaval in the equity structure of several existing banks that might not be in the best interest of the industry and hence the new norms should not be made applicable on a retrospective basis[4]

***Voting rights of shareholders***

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[4] Economic Times, October 11, 2004.

Voting rights constitute a very important component of a system of corporate governance. The influence of structure of shareholding in a firm on the structure of corporate governance depends on the legal provisions about voting rights of the shareholders. Insiders may control the firm either by owning a outright majority of voting shares or by owing a significant minority holding and simultaneously using some combination of parallel devices to augment control over the company. In case of restricted voting rights, the promoter may use non-transparent means to augment its control over the firm. One such means is creation of surrogate companies.

RBI guidelines do not allow companies to hold shares in a bank directly[5] and companies that have indirect holdings in banks do not get control or voting rights. On the single-entity holding limit, the guidelines in Banking Regulation Act, 1949 stipulate that those that manage to acquire more than 10 per cent over a period of time will have their voting rights capped at 10 per cent, irrespective of the level of shareholding. Despite the single-entity holding norm, it is difficult to trace the origins of all the surrogate companies till a full-fledged audit is complete. Many companies own shares in banks by floating firms in other names or through subsidiaries of shell companies or via special purpose vehicles. They also float financial companies or insurance ventures that buy stakes in private sector banks through bilateral off-market deals or through stock market transactions. Banks resorted to a similar practice by floating non-banking finance companies to skirt exposure norms while lending. The issue of surrogate shareholders has assumed considerable

[5] The SS Tarapore committee on fuller capital account convertibility had proposed allowing companies to own banks but RBI did not favour this suggestion, fearing potential conflict of interest.

significance as they have, in some cases, succeeded in wielding control over such critical decisions as lending, treasury, investment and key appointments. Clearly the voice of surrogate companies belongs to original owner or promoter. Any other entity, having only a pecuniary motive would not gain by pursuing an ownership motive. Such returns can be derived even when investments are made as a single entity. The issue of surrogate shareholdings by companies is critical for old-generation and weak private sector banks, since they need capital for expansion and are, therefore, vulnerable to acquisition.[6]. It appears that the surrogate companies are a natural corollary to the of the "control motive" of the original owners namely promoters.

The guidelines announced by RBI in January 1993 restricted the maximum voting rights of an entity to 1% of total voting rights. It is argued that such restriction act as safeguards would prevent takeovers of banks. However, there is not much merit in this argument as, members of one family could always collude and buy up one per cent of shares each. It is observed that such rules are circumvented easily and one may even secure control of a bank. We have come across an instance in which B Ratnakar, the late former chairman of Canara Bank and promoter-chairman of Fairgrowth Financial Services Ltd. In 1991 had secured control of Nedungadi Bank through a disguised takeover. He bypassed the rules by distributing his among several of his supporters and brokers. It may be argued that if an entity buys and retains shares exceeding the voting rights, the reason can not just be getting a return as the same or perhaps a higher return may be derived from other sources. Such shares may be diverted into promoter shares and may be used to manipulate share prices. Such shares may also held in anticipation of a rise in their price in the event of

[6] The issue has emerged when leading Mumbai-based real estate company, with interests in financial services attempted a hostile takeover of Ratnakar Bank.

removal of the cap on voting right. With promoter buying the shares of the bank, this will act as market signal for a rise in the share. However, with a rise in net-worth of the promoter does not lead to increase in direct control over the bank. This induces the promoter to induct insiders in the board of directors, which is sought to be countered by introduction of independent directors[7].

It is apparent that the policy of restrictions of voting rights have not achieved its objectives and led to an adverse impact on transparency in corporate governance. The then finance minister, while presenting the budget for 2003-04, had announced that the restrictions imposed by the Banking Regulation Act, 1949, which limited the voting rights to 10 percent shareholding irrespective of shares held would be removed. Meanwhile the centre had also introduced a piece of legislation to remove the cap on voting limit of 10 per cent of shares. The changes in the legal provisions about voting rights will bring in a more transparent relationship between ownership structure and corporate governance structure in a bank. It is also argued by the ministry of finance that such a step is in accordance with the best international practices[8]. The objective of the new legislation is to encourage the foreign banks for acquisitions.

However, RBI is not keen about relaxing the cap for all shareholders because of security reason. It intends to relax the cap to a particular category of shareholders like foreign as well as Indian banks, provided they are being regulated. Currently, foreign banks do not float subsidiary companies in the country because of cap on the voting rights. Except,

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[7] The issue of independent directors has become a very contentious issue.

[8] Financial Express, September 14, 2008.

ING Vysya, all other banks are operating through branch offices[9]. Parent boards can not be convinced to invest in setting up a subsidiary company or buying a private sector bank, when voting rights are not in proportion to their shareholdings[10].

***Shareholding by promoter***

Because of the crucial role played by promoters in corporate governance of private sector banks[11], it has attracted the policy attention by RBI. In terms of the revised guidelines for entry of new private sector banks issued on 3 January 2001, the promoter's contribution for setting up a new bank was restricted to 40 per cent of the paid-up capital of the bank at any point of time. In case the promoter's initial contribution was in excess of 40% they would have to dilute the excess stake after one year of the bank's operation. In February 2002, RBI clarified that foreign direct investment (FDI) up to 49 per cent from all sources would be permitted in private sector. Banks under the automatic route, subject to the conformity with the guidelines issued from time to time. Accordingly, the maximum limit of shareholding of Indian promoters in private sector banks was been raised to 49 per cent of their paid up capital. While presenting the Budget for 2003-04, the then finance minister had announced that limits of foreign direct investment in private sector banks would be taken up to 74 per cent. On June 30, 2003, the government and the Reserve Bank of India (RBI) have decided to allow Indian promoters of private sector banks to hold 74 per cent stake, thereby, bringing it at par with the limit agreed for foreign direct

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[9] ING has management control in the ING Vysya bank with 45% shareholding.

[10] Government has already allowed foreign holding including portfolio investment through foreign institutional investors up to 75%. They are also allowed to own 100% in a bank in India. But, no foreign bank has availed this facility so far except. In other banks, foreign banks are just investors with minority stake like Rabo Bank in Yes Bank with 20% stake and HSBC Bank in UTI Bank with 9% stake.

[11] It is well-known that the debacle in Global Trust Bank and Nedangudi is due to the dubious role promoters.

investment. Draft guidelines on ownership and governance in private sector banks announced on July 2, 2004 stated that promoter's shareholding in case of new licenses will be expected to be brought down to 10 percent in a period of three years if it is higher to begin with. It may be observed while the RBI stand on the promoter's stake has not been quite stable; it has been consistently allowing a longer time frame to reduce their promoter's share to the desired levels in view of the problems faced by the private banks in diluting their promoter's share. The commitment of the government to grant more freedom to foreign capital in banking industry accompanied by provision of a level playing field between domestic and foreign promoters in banking acted against the reduction of domestic promoter's stake in private banking.

Three tentative zones of corporate governance may be constructed based on promoter share. Zone I may be worked out. Zone I involves a very large holding by promoter. This involves only easy incremental step for family businesses, where a little outside capital is brought without any material impact. When the promoter owns 90%, he can only grab 10% more by engaging in manipulations against from the outside shareholders. With low incentive to manipulations by the promoter, corporate governance is likely to work out more or less satisfactorily for such companies, even in countries with weak institutions. The second zone relates to a situation, where a promoter who owns 51% can make a grab for 80% of the cash produced by the business. Such theft presents acute problems because with 51% of shares, the promoter cannot be displaced. It is always possible for the promoter to pass an ordinary resolution, which governs most matters relating to business. Even in countries with sound systems in place, it is difficult to prevent stealing by a promoter who can't be

sacked.

Zone III refers to a situation with a low promoter holding. The incentive for manipulation in Zone III is the greatest because there is a great temptation for a CEO who owns 8% of a company to make a grab for 100% of the cash flow. To gain intuition into the solution for Zone III governance, let us imagine a company with a 100% shareholder "P" who is not the CEO. It is easy to visualise how "P" would regularly take stock of the progress of the business, exercise judgment on strategy, identify and criticise flaws of execution, block theft, pay bonuses, and sack "A" when performance is inadequate. This arrangement is the role model for what zone III governance should aspire to be. Good governance in zone III is achieved by having a board of directors which performs the role of "P". Individual shareholders are too dispersed and generally do not have either the competence or the interest for governance. So the institutional shareholders must recruit the board of directors. This board must recruit the top management team, supervise them, and award their compensation packages. When the CEO misbehaves or mal-performs, the board must sack the CEO. The analogy in shifting from the CEO-as-dictator seen in zone I and Zone II to this zone III corporate governance is like the reduction in power of the head of state that goes with shifting from dictatorship to democracy. It involves setting up the array of checks and balances which is the essence of democracy.

## Section V: Background and methodology

### *Scenario of ownership and governance in private banking industry in India.*

Old private banks have evolved from being regional/co-operative banks in the pre-reform era. They lend to small businesses and hence the transaction costs are very high. A few

of them including Catholic Syrian Bank[12], Nainital Bank, Ratnakar Bank and Tamilnadu Mercantile Bank continue to be closely held. In the context of the minimum capitalization norms and capital adequacy norms the promoters, or the existing shareholders are both unwilling and unable to infuse large additional capital funds in the banks. Old private sector banks with shareholdings concentrated in communities remain fiercely protective of their identities and resist broadening their shareholder base and thus avoid deepening of corporate structures. The Nadar community holds about 80 per cent stake in Tamilnad Mercantile Bank and the coastal-based Brahmins of Mangalore control Karnataka Bank. The Vysyas from Tamil Nadu have considerable say in Karur Vysya Bank and Laxmi Vilas Bank. The Syrian Catholic community dominates Catholic Syrian Bank. Bank of Madurai was controlled by the Chettiar community in Tamil Nadu. Such communities controlling the banks also enjoy a formidable political clout. In an attempt to retain their control, the promoters in such banks have entered into a direct conflict with the regulator, which has emerged as a formidable corporate governance issue. In an extreme manifestation of this conflict, it is observed that Tamilnadu Mercantile Bank is fighting a battle with RBI which is seeking to change the board of directors[13]. Clearly better governance is possible only after ushering in broad-based ownership of such banks, which involves a reduction in promoter shareholding and minimize the risk of misuse or imprudent use of leveraged funds.

[12] This provides to the latest example tussle for control, which has the added dimension of intervention of a church.

[13] . Economic Times 12 October

An old bank with string links with a community would approve merger with a PSB instead of a private bank having links with another community. But the current law does not allow a normal merger through exchange of shares. The precondition of such a merger is that the capital of the private bank will have to be wiped out. The regulator has to wait till the bank slips to a point of no return. Such mergers draw bad press and politically embarrassing as they are preceded by a moratorium on depositors withdrawing funds. This is a very interesting example, where introduction of a new regulation leads to emergence of a conflict, while a presence of already existing regulation partially operates against resolution of the conflict.

Inadequate capitalisation is the main cause of bank failures, hostile take-over and financial instability in general. May small banks have fallen prey to hostile takeover by larger monopoly industrial houses. We have the case of Bank of Sangli is attempted hostile takeover by Mittals; Madura Bank by Kotak Mahindra; Bank of Rajasthan by Bangurs; Catholic Syrian Bank by the House of Birlas and Thailand-based Shyam Vidya Group ; and Nedungudi Bank by the now famous Fairgrowth Financial Service. We also know that the Bank of Karad was manipulated and controlled by a few brokers only because it had a paid up capital of only Rs.30 lakhs while it had a business turnover of over Rs. 80 crore. The threat to banks with small equity base need not be from outside alone. Such banks may be subject to bitter squabbles among majority shareholders for control. If such a battle for control of the bank is prolonged, it may to lead to poor governance and control systems as with the case of United Western Bank Limited. It apparently how noncompliance of RBI norms about minimum capitalisation by promoters in old private banks lead to creation of conflict between majority owners due

to limited size of equity.

It has been noted that among various reasons, disproportionate involvement with share market is the most important reason of instability of private sector banks. The involvement takes various forms: lending to stock brokers beyond the stipulated limit, taking shares as collaterals, issuing drafts to stock brokers without payment. This may be attributed to excessive risk appetite of the banks, which is disproportionate to their capacity to withstand the adverse consequences arising out of their involvement with the stock market. Disproportionate involvement with the stock market by the banks was facilitated by means of connivance of bank management[14] with stockbrokers, which ultimately led to bank failure. It is observed that in some cases, irrespective of their actual holdings, the promoters of private sector banks can run the show and influence every decision. The debacle of Global Trust Bank[15] and Nedangudi Bank[16] were due to manipulations by the promoter to gain at the cost of other shareholders. This brings us to the question of banking institution's relationship to its promoters. Should a bank's operations be determined by the sole objective of generating returns to its promoters?

### *Hypotheses of the study*

The new banks had to fully comply with the requirement of paid up equity capital of one

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[14] The promoter of the failed "Nedagudi Bank" was himself a stock broker.

[15] A web of political and business links and unconventional risk management and deal making style made Ramesh Gelli a high-flying banker-promoter. It was alleged that he was engaged in backseat driving even after being made to resign. As late as 2003, he had reportedly had facilitated a Rs 10 crore loan to float on line lottery business to an industrial group with chaotic financial track record in the past. Senior bureaucrats in the Union Finance Ministry and politicians indicated the relaxed vigilance in the past over the GTB might be attributed to political factors. Business Line, July 27, 2004, page 8.

[16] Nedungadi bank had violated exposure norms and had indulged in share arbitrage which is banned by RBI. Interestingly, one of the three brokerages through which the share arbitrage was undertaken was by a tainted stock broking firm, which was barred by SEBI in 1998 from undertaking broking business for its alleged involvement in price rigging of scrips of Nedungudi Bank, among other scrips.

billion, as laid by the new regulation. However, old banks have been functioning for a very long time with very small equity capital. We have already discussed that, some old banks have very small equity base and they are very much resistant to broadening their equity base[17]. This leads us to formulate a hypothesis that the equity base of the old banks is smaller than new banks. With very small equity, the shareholders in old banks have been in the control of a very large volume of deposits, because of the trust reposed in the bank in the community built up over a very long period of time. This leads one to hypothesize that deposits per unit of shareholding will be larger in an old bank compared to a new bank Alongside, it is hypothesized that ratio of deposits to equity for closely held[18] old banks is higher than other old banks, as it expected that they have relatively smaller equity.

It is hypothesized that a bank with a lower equity base will have a higher promoter share. A bank with a large equity need not have the same structure of shareholding like a bank with a smaller equity. Thus, we hypothesize different structure of shareholding in these two groups of banks due to following reasons. Firstly, the expectation that size of the equity is different between old and new. Secondly, old banks have evolved over a long period of time and new banks are new generation banks, which are product of deregulation of banking industry. While these groups operate within legal and regulatory prescriptions and constraints, there preferences for asset composition, philosophies and risk appetite need not be same. It is already established in the literature that these two groups constitute two distinct strategic groups because they conduct their operations differently. Their differential conduct provides an additional input in the hypothesis of

[17] For example, TamilNad Mercentile banks had an equity capital of a mere 28 lakhs even in 2008.
[18] A firm whose shares of common stock are owned by relatively few individuals and are generally unavailable to outsiders.

form different ownership pattern of old and new banks. The idea behind the hypothesis is based on link between ownership structure and conduct in banks.

There have been frequent changes in the policy of RBI with regard to promoter shareholding. Interestingly, with announcement of the every policy, the banks were provided some time to comply with the regulations. It was felt that the prevalent conditions in the capital market did not provide an opportunity to reduce promoter stake. The regulations raised the level of promoter shareholding from 40% in February 2002 to 74% June 2003, leading us to expect no reduction in promoter shareholding in private banks over time. However, after introduction reforms in banking it is likely that institutional and non-institutional investors may have increased their stakes in private banks in search of higher market value for shares, consequent to ushering in of an expectation of mergers between banks. It will be interesting to examine whether the influence of promoters and institutions over decision making in private banks has expanded over time

***Data***

The data on shareholding comes is collected from "Capitaline". It is a huge an electronic database of financial and non-financial information of more than 10,000 Indian companies. It contains, among others, detailed time series information on the structure of shareholding of various companies. The study uses the data set related to shareholding in private banks organised on the basis the following entities: Foreign Promoter & Group, Indian Promoter & Group, Institutions, Non-Institutions and lastly, custodians against depository receipts[19]. Data on private banks other than shareholding is collected from a

[19] A depositary receipt is a type of negotiable financial security that is traded on a local stock exchange but

RBI Publication known as "Statistical tables relating to banks" for different years covered by the study.

***Methodology***

There are six components of the methodology used in the study. The first component relates to construction of indexes. Constructions of the indexes go through the following process.

(i) Firstly, mean shareholding by promoters, public shareholders, institutions and custodians against depository receipts in new and old banks in 2002 is set at 100 and accordingly shareholding by these different entities in these two groups of banks are adjusted. The figures so generated are designated as absolute index. There are two sequences of such indexes, one for old banks and the other for new banks.

(ii) In the next step, the figures of mean shareholding of different entities in new banks so generated are divided by the corresponding figures for the old banks, over the period from 2002 to 2008.

(iii) In the final step, the resulting figure for 2002 is set at 100 and the figures for the following years are derived accordingly, resulting in construction of the series representing relative index.

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represents a security, usually in the form of equity that is issued by a foreign publicly listed company. The depository receipt, which is a physical certificate, allows investors to hold shares in equity of other countries. The DR is created when a foreign company wishes to list its already publicly traded shares or debt securities on a foreign stock exchange.

The second component of the methodology relates to use of graphical technique to represent the relative index which will be devised as above. It facilitates the analysis of changes in mean shareholding of different entities in new private banks over time relative to old banks.

The third component of the methodology, used in the study, relates to t test. One-tailed, two tailed and paired t tail tests are used under the assumption of unequal population variances. They are used for the following purposes.

i. To compare mean equity base in old and new banks

ii. To compare mean level of ratio of deposit to equity in the two groups.

iii. To compare mean level of promoter shareholding in the two groups of banks

iv. To compare level of promoter and institutional shareholding in all banks over a period of time.

In the fourth stage we have used canonical discriminant analysis to test for existence of differences in shareholding pattern between groups of old and new banks. Discriminant analysis is used to determine which variables discriminate between two or more naturally occurring groups[20]. Discriminant Analysis may be used for two objectives: either if we wish to assess the adequacy of classification, given the group memberships of the objects under study; or we wish to assign objects to one of a number of (known) groups of objects. Discriminant Analysis may thus have a descriptive or a predictive objective.

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[20] *For interpretation of Discriminant Analysis see Morrison, D. G. (1969)*

In both cases, some group assignments must be known before carrying out the Discriminant Analysis. Such group assignments, or labeling, may be arrived at in any way. Usually, some preliminary tests like a t-test are used for group assignment. We have not chosen to do so because in our case the two groups have evolved historically and do exist as such. Thus, in our analysis “we wish to assess the adequacy of classification, given the group memberships of the objects under study.” The purpose is descriptive. So the question that discriminant analysis answers is as to whether the distinct groups “old and new” actually represent different conduct or behaviour or whether their grouping is merely historical, having no bearing on their behaviour.

Linear Discriminant Analysis is the 2-group case of Multiple Discriminant Analysis. It optimally separates two groups, using the Mahalanobis metric or generalized distance. It also gives the same linear separating decision surface as Bayesian maximum likelihood discrimination in the case of equal class covariance matrices.

A discriminant function, also called a canonical root, is a latent variable which is created as a linear combination of discriminating (independent) variables, such that $L = b1x1 + b2x2 + ... + bnxn + c$, where the b's are discriminant coefficients, the x's are discriminating variables, and c is a constant. This is analogous to multiple regression, but the b's are discriminant coefficients which maximize the distance between the means of the criterion (dependent) variable. There is one discriminant function for 2-group discriminant analysis.

Wilks' lambda or an F-test is used to test the significance of the discriminant function as a whole. A significant lambda means one can reject the null hypothesis that the two groups

have the same mean discriminant function scores and conclude the model is discriminating.

The classification functions can be used to determine to which group each case most likely belongs. There are as many classification functions as there are groups. Each function allows us to compute classification scores for each case for each group, by applying the formula:

$$S_i = c_i + w_{i1}*x_1 + w_{i2}*x_2 + ... + w_{im}*x_m$$

In this formula, the subscript i denotes the respective group; the subscripts 1, 2, ..., m denote the m variables; $c_i$ is a constant for the i'th group, wij is the weight for the j'th variable in the computation of the classification score for the i'th group; xj is the observed value for the respective case for the j'th variable. Si is the resultant classification score. We can use the classification functions to directly compute classification scores for some new observations. Once we have computed the classification scores for a case, it is easy to decide how to classify the case: in general we classify the case as belonging to the group for which it has the highest classification score (unless the a priori classification probabilities are widely disparate). Then we compare the predicted classification with the actual classification to find out how discriminant analysis has performed. The discriminant analysis is carried out on an annual basis to test whether variables discriminating between ownership characteristics of the old and new groups are changing.

In the fifth stage, we use a logit model with the help of a Generalized Estimating Equation, (GEE) by fitting a population averaged panel regression for generalizing the findings of discriminant analysis. GEE models are used in cross-sectional time-series models. In particular, GEE models estimate generalized linear models and allow for the specification of the within-group correlation structure for the panels, which are also known as population-averaged panel-data models.

They allow for correlation without explicitly defining a model for the origin of the dependency, hence they are most suitable when the random effects and their variances are not of direct interest. The focus is on estimating the average response over the population ("population-averaged" effects) rather than the regression parameters that would enable prediction of the effect of changing one or more components of X on a given individual. GEEs are usually used in conjunction with Huber-White standard errors.

Huber-White standard errors are standard errors that are adjusted for correlations of error terms across observations, especially in panel and survey data as well as data with cluster structure. This type of adjusted errors is also called sandwich, robust or empirical standard errors. Once obtained, these estimated errors should be used instead of traditional standard error estimates for inferences and hypothesis testing of the econometric model.

In the marginal mean model we assume the marginal regression model:

$$g\,(E\,[Yij \mid xij]) = X'ij\ \beta \qquad (4)$$

Where Xij is a p times 1 vector of covariates, consists of the p regression parameters of interest, g (.) is the link function, and denotes the jth outcome (for j=1... J) for the ith subject (for i=1,., N).

The link function is:

$$g(a) = \log(a/(1-a)) \tag{5}$$

[g (.) is a Logit link for binary data on old and new banks], where ‘a’ is the probability of being a new bank. We use a population averaged model not a random effects model.

Random-effects estimators (or other cluster-specific estimators) fit the model

$$\Pr(Y_{ij}=1 \mid X_{ij}, u_i) = F(X_{ij}\, b + u_i) \tag{6}$$

whereas population-average estimators fit the model:

$$\Pr(Yij=1 \mid Xij) = G(Xij\, b^*) \tag{7}$$

The population-averaged model does not fully specify the distribution of the population. The subtle point is that b and b* are different population parameters. Hence, the estimators are estimating different things. In practice, however, b and b* are often very close.

The subtle difference between b and b* is explained below. We are looking at:

Outcome: (Yij) [New Bank vs. Old Bank] w.r.t.

A set of predictors $X_{ij}$: [spread, NPA, DIV…]

Then, under the cluster-specific model (random effects model)

$$\text{Logit Pr } (Y_{ij}=1 \mid X_{ij}, u_i) = a + X_{ij}\, b + u_i \quad (8)$$

the odds ratio

$$OR_{cs} = \frac{\Pr (Y_{ij}=1 \mid X_{ij}=1, u_i)/\Pr (Y_{ij}=0 \mid X_{ij}=1, u_i)}{\Pr (Y_{ij}=1 \mid X_{ij}=0, u_i)/\Pr (Y_{ij}=0 \mid X_{ij}=0, u_i)} = \exp(b) \quad (9)$$

represents the odds of the bank being a new bank if the predictors take certain values compared with the odds of the same bank being an old bank.

Under the population-averaged model

$$\text{Logit Pr } (Y_{ij}=1 \mid X_{ij}) = a + X_{ij}\, b^* \quad (10)$$

the odds ratio

$$ORpa = \frac{\Pr (Yij=1 \mid Xij=1)/\Pr (Yij=0 \mid Xij=1)}{\Pr (Yij=1 \mid Xij=0)/\Pr (Yij=0 \mid Xij=0)} = \exp (b^*) \quad (11)$$

represents the odds of an ‘average’ bank being a new bank compared with the odds of an ‘average’ being an old bank.

Rather than saying “average”, sometimes we speak loosely and say the odds of a bank “picked at random” being new compared with the odds of another bank “picked at random” being old.

The main equation that we shall be estimating using a Generalized Estimating Equation, with a logit link function, a binomial family (pdf) and no intercept term is given below:

$$\text{Logit Pr } (Y_{ij}=1 \mid X_{ij}) = a + X_{ij}\, b^* \qquad (12)$$

*Where;*

**$Y_{ij}$=**1 stands for new banks

**$X_{ij}$ =** prom, npinst, npni, cust[i].

The intercept term is interpreted as the proportion of the group in the total industry. In this case it does not affect the odds of being a new bank. That would be the case only if there are network economies.

In the sixth stage, we have developed an analytical tool in a matrix for explaining basis of conflict between regulator and promoter. The matrix identifies different zones of corporate governance and is named as "CG Problem Identification Matrix." The essence of problem of corporate governance is existence of dichotomy between cash flow rights and control rights. Cash flow/ownership rights of a shareholder refer to his earning flowing from ownership of shares and it depends on the volume of shareholding held by him. But the influence of the shareholder on the functioning of the corporation depends on control rights, which depends on his voting right, i.e., the ability to elect the board of directors and influence or dictate decisions that require shareholder approval. If there is "one share, one vote principle", cash flow rights are exactly proportional to control rights, an ideal corporate democracy exists.

While proportionality between cash flow and voting rights is the requirement of ideal corporate governance in an ordinary firm, such does not turn out to be true for a bank.

The reasons, as referred earlier relates to differences between a bank and a firm. A bank, unlike a firm is a public financial institution, which is highly leveraged due to deposits accessed by it. Because of low equity base, even 100% ownership of equity capital does not justify even a low key control on use of deposits, let alone a significant control. In this scenario, it is duty of the regulator to fix the control rights at a level, which is far lower than the cash flow rights of the promoter. Ideally speaking, regulator would like to create a situation, where the cash flow rights are highest and the voting rights are the lowest. Clearly, the intention of the promoter is just opposite to regulator. He wants to maximise his control on the bank while investing minimum. For him, the zones of interest would the ones which involve control right higher than cash flow rights.

**Figure I: CG Problem Identification Matrix**

| **Dimensions** | **Control rights** | | | |
|---|---|---|---|---|
| | **High** | First Preference for regulator | Third Preference for regulator | No Conflict |
| | **Medium** | Second Preference of regulator | No Conflict | Second preference for Promoter |
| **Cash-flow rights** | **Low** | No Conflict | Third Preference of Promoter | First Preference of Promoter |
| | | **Low** | **Medium** | **High** |

Cash flow and control rights are represented on the vertical and horizontal axes respectively. Three levels of these rights are represented in the matrix. They create six combinations of these rights. The matrix may be divided into three zones, each zone comprising of three combinations of the two rights. The diagonal from south west to north east represents an ideal zone of corporate democracy, as there exists no divergence between cash flow and control rights.

The zone above the diagonal is the zone of interest to the regulator. The zone comprises of three sub zone, which may be ranked according to the preference of the regulator. The optimum situation for the regulator relates to the sub zone where the highest cash flow rights of the promoters combines with lowest control rights. Next in preference for the regulator is the sub zone with lowest control rights along with medium cash flow rights. The least preferred sub zone for the regulator consists of one where medium control coexists with highest cash flow rights.

The zone below the diagonal is the zone of interest to the promoter. The zone comprises of three sub zones, which may again be ranked according to the preference of the promoter. The optimum situation for the promoter relates to the sub zone where the lowest cash flow rights of the promoters combines with highest control rights. Next in preference for the promoter is the sub zone with highest control rights along with medium cash flow rights. The least preferred sub zone for the promoter consists of one where medium control coexists with lowest cash flow rights.

It will be interesting to analyse how the promoter will react when legal constraints are imposed on its control rights. It is here surrogate ownership will come into picture. The point is refereed in an earlier section. It suffices to state that the promoter, against the

wishes of the regulator, uses surrogate ownership to restore himself from a sub optimal zone to the zone comprised by the diagonal in the direction from south west to north east. It may be argued that a promoter needs not happy even when the regulators allow him to remain on the diagonal by allowing proportionality between the two kinds of rights. In such a case, instruments like differential voting rights, cross-holding and pyramidal structures assume relevance. Use of differential voting rights is restricted in India while cross holding and pyramidal structure are not known to exist in banking industry in India. Hence these issues are not discussed further.

## Section VI: Results

The first set of results which relate to absolute and relative index are contained in tables from I to III. Absolute index indicates the change in mean shareholding by varies entities in new and old banks on the basis of 2002 as the base period. Relative index reports the change in the mean value of shareholding by different entities over the period 2002-08 in new banks relative to old banks. The absolute indices for old and new banks are presented in table I and II, while relative index is depicted in table III.

Table I: **Absolute index of mean shareholding by different entities in old banks during 2002-08(2002=100)**

| Year | Indian Promoters | Institutions | Public |
|---|---|---|---|
| 2003 | 108.73 | 53.09 | 102.60 |
| 2004 | 108.06 | 79.94 | 97.88 |
| 2005 | 108.00 | 98.40 | 94.33 |
| 2006 | 107.90 | 124.45 | 85.83 |
| 2007 | 107.85 | 167.86 | 78.64 |

| 2008 | 103.19 | 229.14 | 65.43 |
|---|---|---|---|

Table II: **Absolute index of mean shareholding by different entities in new banks during 2002-08(2002=100)**

| Year | Foreign Promoters | Indian Promoters | Institutions | Public | Custodians against depository receipts |
|---|---|---|---|---|---|
| 2003 | 85.67 | 92.78 | 137.45 | 82.49 | 252.01 |
| 2004 | 82.86 | 75.65 | 148.44 | 103.60 | 250.22 |
| 2005 | 62.78 | 71.36 | 145.40 | 95.26 | 532.73 |
| 2006 | 62.92 | 70.90 | 179.81 | 84.95 | 430.04 |
| 2007 | 57.02 | 69.61 | 192.54 | 77.35 | 482.06 |
| 2008 | 66.57 | 43.63 | 224.22 | 92.10 | 555.15 |

Table III: **Relative index of shareholding: New banks to old banks during 2002-08(2002=100)**

| Year | Indian Promoters | Institutions | Public |
|---|---|---|---|
| 2003 | 85.33 | 258.88 | 80.40 |
| 2004 | 70.01 | 185.69 | 105.84 |
| 2005 | 66.07 | 147.76 | 100.99 |
| 2006 | 65.70 | 144.48 | 98.97 |
| 2007 | 64.54 | 114.70 | 98.35 |
| 2008 | 42.28 | 97.85 | 140.76 |

Indices complied from data for shareholding by foreign promoters as well as custodians against depository receipts are reported for old banks because these entities did not hold any share for the major part of the period covered by the study. Table I reveals a rise in mean shareholding in old banks over time by institutions along with a fall in public shareholding as well shareholding by Indian promoters. Table II reveals fall in mean shareholding of Indian and foreign promoter in new banks over time along with a rise in shareholding by institutions, public and holders of Custodians against depository receipts. To sum up, absolute indices reported in tables I and II indicate that the mean shareholding by Indian promoters and institutions moved in the same direction in new and old banks, while mean shareholding by public moved in different directions.

The inability of the absolute index to identify any existing difference in the pattern of change in mean shareholding by Indian promoter, and institutions rationalizes the use of relative index. A look at table III reveals the difference between old and new banks with respect to the pattern of change in mean shareholding by these two entities, despite the

fact that shareholding by different entities has undergone similar changes over time. It implies that mean shareholding by Indian Promoters in new banks fell faster as compared to old banks. It also implies that mean shareholding by institutions in new banks rose faster in the initial period, but it got reversed later. Overall mean shareholding by institutions in old banks rose faster during the major part of the study, as revealed by figure III.

The next set of results is presented in tables from IV to VII. They relate to equity base of the banks and their deposit to equity ratios. The results provided in table IV are in conformity with the hypothesis of smaller equity base of old banks as compared to new banks. In view of the minimum capital requirement needed for setting up of a new bank, low equity base of old banks makes them a very attractive target for take over. However, since these takeover attempts are by closed groups, any successful takeover is not likely to represent an improvement in corporate governance. This has prompted RBI to closely monitor the situation and no hostile bid will be successful without support from RBI.

**Table IV: Test of significance of difference between mean level of equity in old and new banks: 2002-2008**

| Equity level | 2001-2002 | | 2002-2003 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 2403.81 | 24601.56 | 2743.85 | 25700.89 |
| Variance | 5334619 | 753000000 | 5493973 | 739000000 |
| Observations | 21 | 9 | 20 | 9 |
| Hypothesized Mean Difference | 0 | | 0 | |
| Degrees of freedom | 8 | | 8 | |
| t Statistic | -2.42b | | -2.52b | |

| Equity level | 2003-2004 | | 2004-2005 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 2860.35 | 24300.6 | 4272.429 | 30841.13 |
| Variance | 5566707 | 723000000 | 15109523 | 1070000000 |

| Observations | 20 | 10 | 21 | 8 |
|---|---|---|---|---|
| Hypothesized Mean Difference | 0 | | 0 | |
| Degrees of freedom | 9 | | 7 | |
| t Statistic | -2.51b | | -2.29b | |

| Equity level | 2005-2006 | | 2006-2007 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 5979.8 | 34257.13 | 6372.688 | 34712.33 |
| Variance | 47531049 | 1390000000 | 19128405 | 1230000000 |
| Observations | 20 | 8 | 16 | 9 |
| Hypothesized Mean Difference | 0 | | 0 | |
| Degrees of freedom | 7 | | 8 | |
| t Statistic | -2.13b | | -2.40b | |

| Equity level | **2007-08** | |
|---|---|---|
| **Banks** | **old** | **new** |
| Mean | 8261 | 38407.7778 |
| Variance | 28680042.2 | 1791200385 |
| Observations | 14 | 9 |
| Hypothesized Mean Difference | 0 | |
| Degrees of freedom | 8 | |
| t Statistic | -2.12b | |

Footnote: "a" and "b" refer to 1% and 5% level of significance.

The incentive for hostile bids to takeover banks with small equity base gets further strengthened if a large volume of deposits relative to equity exists in such banks. The next hypothesis tests the proposition that deposit to equity ratio is higher in new banks compared to old banks. The results are provided in table V. However, they do not produce in favour of the hypothesis. This may be explained by the fact that the old banks enjoyed an early advantage over new banks in terms of the ratio of deposit to equity. The early advantage of the old bank related to the period, during which the new entrants were making all out efforts to cope up with their competitors, immediately after their

entry. After their successful expansion of deposits by means of offering modern banking facilities, the advantage of old banks with regard to deposit and hence the ratio of deposit to equity was lost to new banks. We extended the period of the test backwards to 1996-97 to confirm the above explanation. The results confirming our reasoning is provided in table VI.

**Table V: Test of significance of difference between mean level of proportion of deposit to equity in old and new banks: 2002-08.**

| deposit to equity ratio | 2001-02 | | 2002-03 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 828.71 | 40.460465 | 902.8936 | 44.454975 |
| Variance | 8222806 | 376.20606 | 10392806 | 578.2383 |
| Observations | 21 | 9 | 20 | 9 |
| Hypothesized Mean Difference | 0 | | 0 | |
| Degrees of freedom | 20 | | 19 | |
| t Statistic | 1.25 | | 1.19 | |

| deposit to equity ratio | 2003-04 | | 2004-05 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 985.541 | 57.734343 | 994.5635 | 56.5773336 |
| Variance | 12068658 | 857.33749 | 13875727 | 2137.47027 |
| Observations | 20 | 10 | 21 | 8 |
| Hypothesized Mean Difference | 0 | | 0 | |
| degrees of freedom | 19 | | 20 | |
| t Statistic | 1.19 | | 1.15 | |

| deposit to equity ratio | 2005-06 | | 2006-07 | |
|---|---|---|---|---|
| Banks | old | new | old | new |
| Mean | 1076.248 | 83.8608645 | 1489.18 | 110.518099 |
| Variance | 16995932 | 4002.95592 | 28495126 | 7030.52944 |
| Observations | 20 | 8 | 16 | 9 |
| Hypothesized Mean Difference | 0 | | 0 | |
| degrees of freedom | 19 | | 15 | |

| t Statistic | 1.076207 | | 1.03285 | |
|---|---|---|---|---|

| deposit to equity ratio | 2007-08 | |
|---|---|---|
| Banks | old | new |
| Mean | 181.598259 | 3149.55511 |
| Variance | 24035.4817 | 82665825.9 |
| Observations | 14 | 9 |
| Hypothesized Mean Difference | 0 | |
| degrees of freedom | 8 | |
| t Statistic | -0.97 | |

**Table VI: Test of significance of difference between mean level of proportion of deposit to equity in old and new banks: 1996-2001.**

| ratio of deposit to equity | 1995-1996 | | 1996-1997 | | 1997-1998 | |
|---|---|---|---|---|---|---|
| Banks | old | new | old | new | old | new |
| Mean | 361.5793 | 5.47664 | 438.0207 | 11.45382 | 521.4281 | 17.54636 |
| Variance | 698636.5 | 19.37664 | 962302.9 | 53.11555 | 1593430 | 75.84296 |
| Observations | 24 | 9 | 24 | 10 | 24 | 10 |
| Hypothesized Mean Difference | 0 | | 0 | | 0 | |
| Degrees of freedom | 23 | | 23 | | 23 | |
| t Statistic | 2.08b | | 2.13b | | 1.95b | |

| ratio of deposit to equity | 1998-1999 | | 1999 | -2000 | 2000-01 | |
|---|---|---|---|---|---|---|
| Banks | old | new | old | new | old | new |
| Mean | 487.2597 | 23.43506 | 595.284658 | 66.21263 | 695.505315 | 43.04953 |
| Variance | 2247777 | 119.4802 | 3984525.13 | 12037.22 | 5760548.06 | 535.7634 |
| Observations | 23 | 10 | 22 | 10 | 22 | 9 |
| Hypothesized Mean Difference | 0 | | 0 | | 0 | |
| Degrees of freedom | 22 | | 21 | | 21 | |
| t Statistic | 1.48b | | 1.23 | | 1.27 | |

Footnote: "a" and "b" refer to 1% and 5% level of significance.

Table VI reveals that during period from 1995-96 to 1998-99, deposit to equity ratio was

significantly higher for old banks as compared to new banks. However, old banks lost this advantage after 1999. However, these results do not reveal the bank-specific scenario with regard to equity and deposit. Even when the mean proportion of deposit to equity for old banks has failed to remain larger compared to the new banks, it is quite possible that some old banks enjoys a substantially higher ratio, increasing manifold the incentives for a hostile takeover of these banks. This leads us to rank all the banks in terms the proportion of their deposit to equity. The purpose of this exercise is to attempt an explicit comparison of old and new banks on the one hand and closely held old banks with other old banks on the other. The results of these exercises in produced in the table VII.

A few striking observations may be made form the table VII. There are four closely held banks among the old banks which are provided in bold letters to facilitate easy identification and comparison. They include TamilNad Mercantile Bank, Catholic Syrian Bank, Nanital Bank and Ratnakar Bank. Amongst these banks, TamilNad Mercantile Bank has always managed to retain the top slot during the period of the study. The ratio of deposit to equity ratio associated with it in different yeas has remained very high, almost out of line with any other bank. Another bank called Catholic Syrian bank also was associated with a very high. Ratio and was second only to TamilNad Mercantile Bank in 2007-08. No wonder these banks have been facing ownership squabbles. In the former, two factions of the shareholders belonging to the Nadar community have been at loggerheads in their attempts to own the bank. The second bank is currently in the process of being taken over by Federal Bank in presence of stiff resistance from the Catholic Syrian Church. The results of a t test do not provide results with such interesting

interpretations. Arrangement of the banks in the ascending order of the ratio of deposit to equity demonstrated that the banks with largest ratio of deposit to equity are closely held banks which have been subject to take over threats and ownership squabbles. The status of corporate governance in these banks deserves to be analyzed with care. They are public financial institution without public control. It is true that such closely held banks are not public limited companies as their shares are not traded in stock exchanges. However, any bank accepts deposits from public and hence is a public financial institution, irrespective of the ownership of its equity capital. Large volume of deposits compared to low levels of equity in few above mentioned raises very serious concern. A dilemma relating to a bank is that there is no role for depositors in its corporate governance, even when they have the largest stake in corporate governance in a bank. No deposit insurance system is capable for fully addressing the dilemma between risk loving promoters and risk averting depositors, because it does not fully cover the depositors. In India, the depositors are covered only to the extent of one lakh Rs.

**Table VII: Deposit to equity ratio of banks: 2002-2008.**

| S.No. | Name of banks | 2001-02 | 2002-03 | 2003-04 | 2004-05 |
|---|---|---|---|---|---|
| 1 | **TamilNad Mercantile Bank** | 13321.39 | 14587.79 | 15729.57 | 17238.86 |
| 2 | Ganesh bank of Kurundwad | 117.26 | 112.51 | 114.42 | 119.47 |
| 3 | Vyasa Bank | 356.69 | 406.13 | 462.61 | 553.47 |
| 4 | Jammu and Kashmir Bank | 268.09 | 304.46 | 386.76 | 446.38 |
| 5 | **Catholic Syrian Bank** | 302.50 | 331.40 | 364.70 | 376.86 |
| 6 | Federal Bank | 408.16 | 504.02 | 619.33 | 231.60 |
| 7 | Nainital Bank | 121.60 | 44.58 | 50.59 | 62.22 |
| 8 | Karur Vyasa bank | 696.68 | 312.12 | 328.78 | 371.09 |
| 9 | Bank of Rajasthan | 39.45 | 50.01 | 68.85 | 75.49 |
| 10 | Karnataks Bank | 518.63 | 205.09 | 232.67 | 89.38 |
| 11 | Bharat Oversea Bank | 115.76 | 136.45 | 156.92 | 174.55 |
| 12 | Sangli Bank | 92.37 | 82.20 | 83.57 | 89.01 |
| 13 | South Indian Bank | 165.63 | 191.82 | 231.41 | 178.11 |
| 14 | Ratnakar Bank | 62.60 | 55.09 | 38.87 | 40.44 |
| 15 | City Union Bank | 82.24 | 96.56 | 118.61 | 128.97 |
| 16 | Lakshmi Vilas Bank | 215.20 | 240.70 | 286.34 | 303.73 |
| 17 | United Western Bank | 150.25 | 180.36 | 215.13 | 215.89 |
| 18 | Nedungadi Bank | 140.99 | ---- | ---- | ---- |
| 19 | Development Credit Bank | 160.72 | 129.91 | 113.67 | 59.46 |
| 20 | Lord Krishna Bank | 26.50 | 29.34 | 40.77 | 23.04 |
| 21 | Dhanalaxmi Bank | 40.20 | 57.33 | 67.24 | 72.95 |
| 22 | Global Trust Bank | 53.09 | 57.03 | 52.73 | ---- |
| 23 | IndsInd Bank | 52.82 | 39.21 | 38.57 | 45.14 |
| 24 | Axis Bank | 64.04 | 73.70 | 90.48 | 115.82 |
| 25 | ICICI Bank | 33.32 | 50.04 | 70.48 | 91.85 |
| 26 | HDFC Bank | 62.74 | 79.33 | 106.78 | 117.32 |
| 27 | Bank of Punjab | 31.94 | 34.19 | 39.40 | 41.02 |
| 28 | Centurion Bank | 23.18 | 18.59 | 53.37 | 34.84 |
| 29 | IDBI Bank | 37.39 | 43.06 | 46.90 | ---- |
| 30 | SBI Commercial and Industrial Bank | 5.62 | 4.94 | 3.73 | 3.31 |
| 31 | Kotak Mahindra Bank | ---- | ---- | ---- | 34.86 |
| 32 | Yes Bank | ---- | ---- | ---- | 3.3152 |

Contd.. from last page

| S.No. | Name of banks | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| 1 | **TamilNad Mercentile Bank** | 18581.68 | 21499.57 | 27393.75 |
| 2 | Ganesh bank of Kurundwad | 74.20 | ---- | ---- |
| 3 | Vyasa Bank | 146.99 | 169.62 | 200.0396 |
| 4 | Jammu and Kashmir Bank | 484.32 | 519.58 | 589.6733 |
| 5 | **Catholic Syrian Bank** | 400.45 | 440.91 | 424.0518 |
| 6 | Federal Bank | 208.86 | 252.15 | 151.5135 |
| 7 | Nainital Bank | 37.50 | 49.36 | 59.66667 |
| 8 | Karur Vyasa bank | 421.40 | 188.73 | 232.6659 |
| 9 | Bank of Rajasthan | 82.66 | 100.55 | 102.9998 |
| 10 | Karnataks Bank | 109.20 | 115.68 | 140.2241 |
| 11 | Sangli Bank | 85.07 | 41.49 | ---- |
| 12 | South Indian Bank | 136.04 | 173.83 | 167.6377 |
| 13 | Ratnakar Bank | 30.69 | 7.52 | 10.51442 |
| 14 | City Union Bank | 146.57 | 186.48 | 200.78 |
| 15 | Lakshmi Vilas Bank | 222.04 | 105.00 | 115.2036 |
| 16 | United Western Bank | 68.57 | ---- | ---- |
| 17 | Development Credit Bank | 41.04 | 29.91 | 34.85284 |
| 18 | Lord Krishna Bank | 24.13 | 19.83 | ---- |
| 19 | Dhanalaxmi Bank | 79.00 | 96.32 | 112.5524 |
| 20 | IndsInd Bank | 51.66 | 55.14 | 59.49191 |
| 21 | Axis Bank | 143.94 | 208.73 | 244.9644 |
| 22 | ICICI Bank | 133.15 | 184.51 | 167.1118 |
| 23 | HDFC Bank | 178.18 | 213.84 | 284.3117 |
| 24 | Bank of Punjab | 66.74 | 94.86 | 98.622 |
| 25 | SBI Commercial and Industrial Bank | 3.78 | 4.88 | 5.2202 |
| 26 | Kotak Mahindra Bank | 21.23 | 33.73 | 47.65036 |
| 27 | Yes Bank | 10.77919 | 29.35857 | 44.87359 |

We now proceed to test the hypothesis to examine whether promoter shareholding in new banks is different from old banks. Table VIII produces the results of such test. The results reported in the table are in accordance with our hypothesis. There is no significant difference between the old and new banks with respect to shareholding by promoter. This perhaps indicates that the promoter share in old and new banks is determined by the same set factors and hence no significance difference emerged.

**Table VeriTest of significance of difference between mean level of promoter shareholding in old and new banks: 2002-08**

| Year | 2001-02 | 2001-02 | 2002-03 | 2002-03 | 2003-04 | 2003-04 | 2004-05 |
|---|---|---|---|---|---|---|---|
| Banks | new banks | old banks | new banks | old banks | new banks | old banks | new banks |
| Mean | 52.31 | 38.46 | 39.37 | 45.98 | 30.11 | 45.74 | 26.18 |
| Variance | 367.26 | 2147.85 | 540.13 | 2034.32 | 694.08 | 2067.59 | 558.87 |
| Observations | 6.00 | 15.00 | 6.00 | 14.00 | 6.00 | 14.00 | 6.00 |
| Hypothesized Mean Difference | 0.00 | | 0.00 | | 0.00 | | 0.00 |
| degrees of freedom | 19.00 | | 17.00 | | 16.00 | | 17.00 |
| t statistic | 0.97 | | -0.43 | | -0.96 | | -1.26 |

| Year | 2004-05 | 2005-06 | 2005-06 | 2006-07 | 2006-07 | 2007-08 | 2007-08 |
|---|---|---|---|---|---|---|---|
| Banks | old banks | new banks | old banks | new banks | old banks | new banks | old banks |
| Mean | 45.72 | 25.93 | 45.68 | 24.78 | 45.66 | 24.46 | 38.52 |
| Variance | 2069.22 | 553.96 | 2072.91 | 507.36 | 2074.65 | 465.76 | 1954.98 |
| Observations | 14.00 | 6.00 | 14.00 | 6.00 | 14.00 | 6.00 | 14.00 |
| Hypothesized Mean Difference | | 0.00 | | 0.00 | | 0.00 | |
| degrees of freedom | | 17.00 | | 17.00 | | 17.00 | |
| t statistic | | -1.27 | | -1.37 | | -0.95 | |

The old banks are characterized by a significantly lower size of equity as compared to the new banks. With significantly higher rise of their equity, we proceed to test whether the distribution of the shareholding in the new banks is different from their older counterparts. A discriminant analysis is conducted at seven points of time to reveal if such differences exist between old and new banks. The results of the discriminant analysis are explained below with the help of the table IX.

**Table IX: Mean shareholding of different groups of shareholders in different groups**

| bank groups | shareholders | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|---|---|---|---|
| old banks | foreign promoter | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 2.92 |
| | Indian promoter | 38.46 | 41.82 | 41.56 | 41.54 | 41.50 | 41.48 | 39.69 |
| | institution | 10.02 | 5.32 | 8.01 | 9.86 | 12.47 | 16.82 | 22.96 |
| | public | 51.52 | **52.86** | 50.43 | 48.60 | 44.22 | 40.52 | 33.71 |
| | Custodians against depository receipts | 0.00 | 0.00 | 0.00 | 0.00 | 1.80 | 1.18 | 0.70 |
| new banks | foreign promoter | **7.12** | **6.10** | 5.90 | **4.47** | 4.48 | 4.06 | 4.74 |
| | Indian promoter | 45.19 | 41.93 | 34.19 | 32.25 | 32.04 | 31.46 | 19.72 |
| | institution | 16.10 | **22.13** | **23.90** | 23.41 | **28.95** | 31.00 | 36.10 |
| | public | 29.37 | 24.23 | 30.43 | 27.98 | 24.95 | 22.72 | 27.05 |
| | Custodians against depository receipts | **2.23** | 5.62 | 5.58 | **11.88** | 9.59 | **10.75** | **12.38** |

Discriminant analysis identified one or few discriminants between the old and new banks in each year. No difference has been observed with regarding the shareholding by Indian promoters between the two groups. Shareholding by institutions and foreign promoters has turned out a significant in three years. Shareholding by custodians against Depository Receipts emerged as a significant in four years. In fact, it emerged the only discriminant in the last two years. All these entities turned out to hold larger shareholding in the new banks compared to the old banks. The only exception is ordinary shareholders which had a significantly higher shareholding in old banks as opposed a new banks. The percentage of banks correctly classified by the discriminant analysis falls within 75% to 90% excepting one year. The result produces evidence to support the hypotheses that new banks are characterized by a different pattern of shareholding compared to old banks.

However, it also demonstrates that the differences in the shareholding pattern between the old and new groups have dwindled over time. This may be indicative of existence of similar pressure on the ownership structure of old and new banks emanating from diverse sources.

The results of discriminant analysis depicted above in table IX show that different variables have turned out to be significant at different points of time. This had led us to examine whether general differences between old and new banks exist with regard to their ownership structure. The technique of panel logit is used in order to generalize the findings of discriminant analysis. The result of such an exercise is provided below.

The GEE shows that the two groups differ on account of all four variables used in the exercise. All these variable show statistically significant p-values. The variables are shareholding by promoter, institutions, public and custodians against depository receipts. The estimated equation is:

$$Logit\ Pr\ (Y_{ij}=1\ |\ X_{ij}) = 1.03*prom - 0.96*npinst - .97*npni + 1.26*cust$$

(P-values) (0.002) (0.39) (0.006) (0)

The above equation appears to be an ordinary regression equation; however, the interpretation is not straight forward. Exp (b), which is the odds ratio for a given independent variable, represents the factor by which the odds (event) change for a one-unit change in the independent variable. Put another way, Exp (b) is the ratio of odds for two groups where each group has a values of Xj which are one unit apart from the values of Xj in the other group. An Exp (b)>1 means the independent variable increases the logit and therefore increases odds (event). If Exp (b) = 1.0, the independent variable has no

effect. If Exp (b) is less than 1.0, then the independent variable decreases the logit and decreases odds (event). If those variables increase then the odds are against an old bank behaving like a new bank. The odds ratio, which is Exp (b), is the factor by which odds (event) changes for a 1 unit change in X. The change factor is not Exp (b)*$\Delta X$. Rather, odds (event) changes by a factor of Exp (b)*$^{\Delta X}$. That is, odds (event) changes by a factor of Exp (b) raised to the power of the number of units change in X.

The interpretation of shareholding by promoter and custodians against depository receipts is positive. That is, if old banks on an average increase the share of promoters and custodians the probability of behaving like a new bank is greater. On the other hand, the interpretation of shareholding by institutions and public is negative, which implies that if the shareholding of institutions and public goes down, old banks are more likely to behave like new banks. This reveals that there are distinctly different patterns in shareholding between old and new banks and therefore, the private banking industry can not be treated as a single whole.

## Table X: Generalized Estimating Equation

| GEE population-averaged model | | | | | Number of obs. = | | | 84 |
|---|---|---|---|---|---|---|---|---|
| Group variable: | gcode | | | | Number of groups = | | | 12 |
| Link: | logit | | | | Obs. per group: min = | | | 7 |
| Family: | binomial | | | | avg. = | | | 7 |
| Correlation: | independent | | | | max = | | | 7 |
| | | | | | Wald chi2(4) = | | | 18.11 |
| Scale parameter: | 1 | | | | Prob. > chi2 = | | | 0.0012 |
| Pearson chi2(84): | 88.47 | | | | Deviance = | | | 74.6 |
| Dispersion (Pearson): 1.053231 | | | | | Dispersion = | | | 0.8881203 |
| class | | Odds Ratio | Std. Err. | z | P>z | [95% Conf. | | Interval] |
| prom | | 1.035 | 0.012 | 3.06 | 0.002 | 1.012269 | | 1.057428 |
| npinst | | 0.962 | 0.018 | -2.06 | 0.039 | 0.9276532 | | 0.998095 |
| npni | | 0.973 | 0.01 | -2.77 | 0.006 | 0.9548586 | | 0.9921314 |
| cust | | 1.265 | 0.08 | 3.74 | 0 | 1.11839 | | 1.431201 |

Now, we proceed to test whether shareholding by promoters and institutions have undergone any change private banks over the period 2001-02 to 2007-08. The result is produced in the following tables, XIA and XIB.

**Table XIA: Results of t-Test: Paired Two Sample for Means Of promoter shareholding**

| | *2001-02* | *2007-08* |
|---|---|---|
| Mean | 42.41619 | 37.43381 |
| Variance | 1636.394 | 1634.216 |
| Observations | 21 | 21 |
| Pearson Correlation | 0.860398 | |
| Hypothesized Mean Difference | 0 | |
| Degrees of freedom | 20 | |
| t statistic | 1.068528 | |

**Table XIB: Results of t-Test: Paired Two Sample for Means of shareholding by institutions**

| | *2001-02* | *2007-08* |
|---|---|---|
| Mean | 11.76143 | 26.71238 |
| Variance | 257.5598 | 385.7302 |
| Observations | 21 | 21 |
| Pearson Correlation | 0.592001 | |
| Hypothesized Mean Difference | 0 | |
| Degrees of freedom | 20 | |
| t statistic | -4.16887c | |

Note: c means significance at 1% level.

It may be observed from the above table that average shareholding by promoters is not significantly different between the two time periods. However, average shareholding for

institutions has significantly during 2007-08 as compared to 2001-02. These two results must be jointly explored to arrive at their implications. In a situation, where promoters are allowed to raise their stake significantly from 40% to 74%, the test revealed no statistically change in shareholding by promoter over the period of the study. The answer must lie in restriction of the maximum voting rights of a shareholder. While there are both cash flow and voting rights associated with shareholding in a firm, the primary interest of the promoters in increasing their stake lies in gain more control over the firm through more voting rights. In absence of any rise in voting rights accompanying the rise in shareholding of the promoter, they are likely to use some non-transparent means, like surrogate holding to augment their control and no significant change in their shareholding is expected to occur. The objective of shareholding by institutions is different from promoter. Their primary motive is to gain for their shareholding in the firm in which they are investing. They will raise their stake in entities, which will provide them with higher expected returns. Thus the distinction between control motive vs. pecuniary motive of the promoters vis-à-vis explains why the shareholding by institutions has significantly increased in private banks over time, while that of the promoters did not.

In the last leg of this section, we use the methodology of corporate governance identification matrix developed in an earlier section. We use the matrix to examine how the impact of ownership structure influences corporate governance through regulation. Currently, regulation caps the voting rights at 10% even cash flow rights exceeds 10%.

Table XII shows that cash flow rights represented by extent of promoter shareholding have increased in old banks, while it decreased in the new banks. The difference between cash flow rights and regulated voting rights results in a notion of deemed loss. Hence, the net notional loss has increased in old banks and the same has decreased in new banks. Interestingly, it has gone down to one third of its initial level in the new banks. This signifies an intensification of conflict between promoter and regulator in the case of old banks and reduction of the same in new banks. No wonder, all the cases relating to bitter conflict between promoter and regulator in private banks we have come across relate to old banks alone. When voting rights are capped at 10%, promoters in old bank raised their shareholding in anticipation of a rise in their control rights in the event of relaxation of this norm. Clearly prompters in old bank have a control motive as opposed to a pecuniary motive, this is mot so for promoters of the new bank, who reduced their shareholding by nearly half over time. In terms of CG identification matrix this meant transition of the promoter in old banks to a zone with equal voting rights while cash flow rights increase, forcing him to move to a zone which is the first preference zone for the regulator. While promoters in old and new banks remain in zones preferred by the regulator, promoters in new banks are better off compared to old banks. On the other hand, with a fall in cash flow rights, while the voting rights remain same, promoters in new banks move to the second preference zone from the first preference zone of the regulator. This heightens the conflict because the objective of the regulator is met but that of the promoter is negated. On policy lesson thrown up by the analysis is that corporate governance of old and new banks should not be equated due to presence of a larger

element of conflict between promoter and regulator in old banks. It is therefore very evident that corporate governance is a problem where the dynamics of relationship between the bank and regulator is vitally affected.

**Table XII: CG Problem Identification Matrix**

| | Old Banks | | | New Banks | | |
|---|---|---|---|---|---|---|
| Year | Norm of voting rights | Cash flow right | Net notional loss | Norm of voting rights | Cash flow right | Net notional loss |
| 2002 | 10 | 38.46 | 28.46 | 10 | 52.31 | 42.31 |
| 2003 | 10 | 41.82 | 31.82 | 10 | 48.03 | 38.03 |
| 2004 | 10 | 41.56 | 31.56 | 10 | 40.09 | 30.09 |
| 2005 | 10 | 41.54 | 31.54 | 10 | 36.72 | 26.72 |
| 2006 | 10 | 41.5 | 31.5 | 10 | 36.52 | 26.52 |
| 2007 | 10 | 41.48 | 31.48 | 10 | 35.52 | 25.52 |
| 2008 | 10 | 42.61 | 32.61 | 10 | 24.46 | 14.46 |

**Section VII: Summary and conclusions**

The issue of corporate governance in banks, christened by Schumpeter as "gatekeepers of development of capitalism", can not be subsumed under any discussion of corporate governance in an ordinary firm. However, the issue of corporate governance in banks has not attracted serious research attention in India. The study uses a concept of corporate governance in the extant literature, which attempts to clarify conflicts underlying the phenomenon at different levels. It points out that a conflict arising between multiple majority owners in a firm, have not received adequate attention in the literature. It was explained later, how noncompliance of RBI norms about minimum capitalisation by promoters in old private banks led to conflict between majority owners due to limited size of equity. Such a conceptual framework of corporate governance in banks drives home the point that corporate governance in banks is more complicated than firms. The vastly

complicated nature of corporate governance in a bank has very significant policy implications.

First, corporate governance in a bank is devoid of any role for depositors, who have the largest stake in a bank. It is here the suggestion of introduction of representatives of depositors on the board of the banks becomes relevant. If this suggestion is not generally acceptable, one may toy with the idea of raising the limit of deposit insurance. The deposit insurance system in the country can not fully address the dilemma because it does not cover deposits beyond one lakh Rs. It should be remembered that banks are the only resort of millions of people including retired personnel, who have entrusted the banks with their life time savings at very low interest rate with only safety of their funds uppermost in their mind.

Secondly, certain legal provisions treat private banks along the same lines of a private company. For example, a provision in the Companies bill 2009 provides for appointment of auditors by private banks like private sector companies. It is argued that such a provision should not be extended to private banks. Otherwise the saga of failed bank Global Trust Bank, audited by Price Water House is likely to be repeated.

The study provides an analysis of the evolving legal framework for ownership and governance of private banks in India in terms of a few elements. They include minimum paid up equity capital, voting rights and promoter shareholding. It is argued that presence of a strong domestic lobby, differences of opinion between RBI and Ministry of Finance and the policy framework for foreign banks have a bearing on the evolution of the regulatory framework of private banks in India. Analysis of voting rights produced interesting conclusions. In an attempt to prevent takeovers of banks, current regulations

restricted the maximum voting rights of an entity to 1% of total voting rights. When promoters can not augment their control through larger ownership of shares, they seek non-transparent means to pursue their objective. It is observed that surrogate ownership has emerged as one of such means. Clearly, disproportional voting rights have not achieved its objectives and led to reduced transparency in corporate governance in private banks in the country. Currently, a bill to align voting rights in the banking sector with the shareholding pattern is under consideration of the government. It may be argued that in the event of restricted voting rights, the promoters use surrogate ownership and control the bank without becoming transparent. There is nothing to loose from the new regulation, which will lead to proportionality between cash flow and control rights in a transparent fashion. However, transparency was not the issue as objective of the new legislation is to encourage acquisitions of private banks by foreign banks.

A significant contribution of the paper is to develop the methodology of CG identification matrix and use it to analyze conflict between promoter and regulator in old and new banks. It is observed that promoters in old banks and new banks have respectively raised and reduced their shareholding leading to move to different corporate governance zones. While both of them remain out of their own preferred zone, promoters in old banks have moved a zone, which is worse compared to promoters in new zone. Such a movement is explained by control motive vis-à-vis pecuniary motive. A significant policy conclusion emerging out of the result is that old and new banks should not be treated similarly doe corporate governance purposes.

The statistical component of the paper provides some interesting conclusions. It is found that the old banks are characterized by a significantly lower equity compared to the new

banks making them very much vulnerable to hostile takeover attempts. It is also demonstrated that old banks had a significantly higher proportion of deposit to equity for the period 1995-1999 as compared to new banks. An arrangement of the banks in terms of ratio of deposit to equity revealed that the ratio is very high for a number of old banks in general and two closely held banks in particular. In fact, one old closely held old bank has consistently managed the highest ratio of deposit to equity throughout the period of the study. With deposit in banks rising faster than equity base, equity holders in banks getting opportunity to use larger volume of deposit per unity equity to optimize their objective function. The study does not find promoter share in new banks to be significantly different from old banks. Quite clearly, none of these groups of banks have taken the issue of reduction in promoter's stake very seriously. However, discriminant analysis revealed existence of significant discriminants between old and new banks in their pattern of shareholding. There occurred no significant change in shareholding by promoters in private banks during 1992-2008. Alongside, there was an increase in shareholding by institutions. This is attributed to the control motive of the promoters as opposed to the pecuniary motive of the institutions.

An important policy implication of the study is that closely held banks should be differently treated by policy maker for corporate governance purposes. This issue assumes great significance as it is observed that a few closely held banks have been consistently managing very high proportions of deposit to equity. A bank is public financial institution, irrespective of how its share capital is owned and transparency in any institution using public money is must. Full control by shareholders over enormous volume of funds belonging to depositors by holding very insignificant volume of equity

is likely to produce adverse consequence. In such a scenario, different kinds of conflicts underlying corporate governance are likely to surface. Lack of appropriate corporate governance may lead to instability, run, and even closure. This enormously harms the depositors with adverse impact on financial stability, which is elevated in the literature .to the level of a public good.

While closely old banks do not comply with RBI norm of capitalization, few of them attempt to float an idea that they are very small banks and hence need a different treatment from RBI. Apparently, they are asking for some relaxations in RBI norms to be applied to them. One needs to counter such an idea and strongly argue about more regulation of such banks. They have the advantage of huge deposit controlled by very less levels equity. Regulators must force introduction of representatives of depositors in their boards, or, contemplate something different but effective. However, this is a tall order, given the political support they enjoy[21].

At any rate, these banks with small balance sheet size are not likely continued in their present form in an intensely competitive era, ridden with high risk. It is observed that only public sector banks have rescued the troubled private sector banks. But this happened only when the entire equity of the private sector bank was wiped out. A normal merger though exchange of shares is not allowed by law. This has to be scrapped. In the current deregulated era, runs and instabilities in private banks keep recurring, and continue to draw bad press.

Finally, it appears that the task of loosening the grip of promoters on private banks, in order to prevent them from using public funds for private gain, appears to be the most daunting task. Corporate governance abuses in private banks constitute a very difficult

[21] TamilNad Mercentile Bank with maximum ratio of deposit to equity is fighting a legal battle with RBI.

regulatory dilemma. But because of its significance for allocative efficiency in the economy, the issue must top the agenda of the regulator. “The gatekeeper of the economy” deserves the best attention in any attempt to set the economy in order.

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i See Table II for description of variables.