IMPACT OF CORPORATE GOVERNANCE ON BANKS PERFORMANCE

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ABSTRACT

This research focuses upon corporate governance and its effect on efficiency of conventional and Islamic banks when there is no proper code of conduct and regulations under SECP. The research data is collected from KSE listing banking sector from period 2006 to 2012.In this research the impact of corporate governance on bank performance technique ROE and ROA is analyzed and these are the two independent variables which are taken in the study. BKSZ have greater impact indicating positive and significant impact on ROE. But the BDSZ have a significant and positive impact on ROA.

Keywords: Corporate Governance, Bank Performance, Banking Sector, Pakistan.

JEL Classifications: G34, G21

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1. Introduction

Corporate governance is a mechanism used to control and direct the affairs of a corporate body in order to serve and protect the individual and collective interests of all its stakeholders. Corporate governance is a system by which organization's are directed and controlled (Cadbury, 1992). Corporate governance is a mechanism through which stakeholder's protect themselves against expropriation by the insiders (Porta, 2000). It is the framework by which the interests of various investors are balanced. Corporate governance provide the techniques by which the problems of corporation investors, which include the shareholders, creditors, management, employees, consumers and the public at large are solved (Cheema et al,. 2013). Corporate Governance assures that business is running well and a good return can be obtained by receiver. Corporate Governance can be defined as it is a very comprehensive system by which various corporations can be controlled and worked. The framework of corporate governance tells the different responsibilities and duties of different people who participate in corporation such as managers, stakeholders and shareholders who get a lot of guidance from corporate affairs. This framework of Corporate Governance also helps in providing objectives to company in business and also helps in judgment of company performance (Jensen & Meckling, 1976). In banking system stakeholders find their direct attention toward bank performance just as in non banking system (Hassan, 1994).

1.2 Objectives of the Research

The main objective of this proposed article is to study the impact of corporate governance on bank system and here are some objectives given as:

- Develop a positive significant relationship between bank and corporate governance.
- Promote goodwill and confidence in banking financial system by corporate governance
- Increase valuation, high profit.
- Higher sales growth and lower capital expenditure.
- Positive correlation between bank and shareholders.

1.3 Research Questions

- How does good corporate governance enhance economic growth as well as investor confidence?
- What is the impact of internal and external control governance mechanism on bank performance?
- How does the profitability of a bank remain same whether it is run by the conventional or the Islamic banks investors?
- Does the conventional banks performance is better than Islamic banks?

2. Literature Review

(Rogers, 2008) analyzes the financial performance in commercial banks of Uganda and the basic principles of corporate governance. According to his opinion reliability is the measure of trust and is the significant boosters of financial performance where as credit risk has a negative relationship with financial performance.

(Okapare, 2010) analyses the basic constraints and bottle necks which hinder effective corporate governance in Nigeria. The barriers included poor adherence to the regulatory frame work, violation of minority shareholders rights, low commitment on the part of boards, faulty monitoring system and above all lack of transparency.

(Attiya Y. Javed & Robina Iqbal, 2008) finds the effect of ownership concentration on a firm performance as well as the effect of ownership identity and block holding on ownership. Using the sample of fifty representative firms from different manufacturing sections of Pakistani economy during 2003 to 2008 the results indicate that greater incentives for ownership concentration are ensured by more investment opportunities.

(Babalola Adeyemi & Ajewole Olaniyi Olowu, 2013) investigates the corporate governance issues which cause poor corporate governance in Nigeria including inadequate transparency, inefficient boards, insider malpractices, lack of disclose fusion of the post of the chairman and that of the managing director and non- separation of ownership from management.

(Onakoya et al., 2009) study the effect of corporate governance on bank performance in Nigeria from 2005 to 2009. They find that corporate governance has negative impact on bank performance. They further find that bad corporate governance fails to win the confidence of the public in the financial banking sector which leads to the reduction savings, profit, investment and output in the economy. They suggest that the short comings can be controlled by banking strategic training of certain courses that promote banking ethics and corporate governance should be launched.

(Geoffrey C. Kiel & Gavin J. Nicholson, 2003) suggest that the international corporate governance research agenda by telling about their corporate governance environment for Australia's largest companies. They conclude that there is a negative relationship between company size as from assets and revenue point of view and the market based performance measure of Tobin's. The companies with greater revenues on a lower asset base have shown strong profitability.

(Fekadu Petros & Gebremeskel, 2010) believe that problems related to corporate governance are similar throughout the world. Therefore some countries including Japan, Ecuador and Thailand have adopted hybrid company laws. The study suggests that with the increasing separation between ownership and control certain changes should be made to address the governance problems.

(Kim et al., 2012) review corporate governance when it comes to ownership structure of domestic owned banks. Ownership structure has vital role as it is a key determinant of corporate governance. Their study utilizes foreign and domestic commercial banks data from 1995 to 2005 in order to examine the impact of corporate governance and bank performance

(Stijn Claessens & Burcin Yurtoglu, 2012) focus upon how corporate governance supports economic stability and what are the requirements to implement good practices. Lack of transparency and by providing insiders the advantage of information that is critical to market integrity results in poor governance. Through more access to financing, good firm performance, fair and favorable treatment of all stakeholders, lower cost of capital better governed corporate frameworks can be established.

(Adel Bino & Shorouq Tomar, 2008) by the using the linear regression analysis they examine the relationship between corporate governance and bank performance. Board composition along with ownership structure matters a lot in the bank performance. The banks with institutional majority ownership have the higher performance. Further the banks become even more efficient with the increase in manager's and board member's ownership. Both the manager and board of directors have to work together for improving bank performance.

(Sami et al., 2009) the better governed firms have better performance and higher valuation. Their measure of corporate governance is positively associated with firm performance. Ownership concentration and board on dependence ensure greater firm performance. The value of firm increases with foreign ownership where as state ownership decreases it.

(Kajola & Sunday O, 2008) explore the relationship between four corporate governance mechanisms and two firm performance measures. These corporate governance mechanisms include board size, chief executive, board composition and audit commute. They suggest that the board size should be within sizeable limit. Different persons should be employed as chief executive and the board chair.

(Romano et al., 2012) analyze corporate governance related to the system. They suggest that board size is not the factor affecting bank holding companies performance. However smaller audit committees that are charged with internal monitoring activates perform better concerning to increase bank's profitability.

(Mohammed & Fatimoh, 2012) suggests that the management has diverse function which may contradict those of the shareholders. In order to avoid such conflicts the management should work on short term out comes but it loses focus on ethical issues which include professionalism efficient corporate management, compliance with regulatory consideration, accountability and proper supervision.

(Jonathan R. Macery & Maureen O' Hera, 2003) explain the role that corporate governance plays in corporate performance and argue that commercial bank pose check corporate governance problems for managers and regulations. There is a positively relationship between corporate governance and bank performance.

(Lawrence D. Brown & Marcus L. Caylor, 2004) suggest that the firms that are better governed earn more profit, are more valuable and are better able to pay out needed case to their shareholders. By using director and executive compensation they measured that good governance is mostly related to good performance. On the other hand by using charter/bylaws they found that good corporate governance is most highly associated with bad performance

(Papanikolaou Ermina & Patsi Maria, 2010) explore the relationship between corporate governance, bank performance and other financial issues. Their study found that there is a negligible negative relationship between corporate governance and bank performance. However there is a significant relationship between bank performance and leverage and sales growth.

(Farooque et al., 2007) they found that the ownership does not significantly contribute to the performance of a firm. However performance makes negative impact on ownership. Corporate governance mechanisms include institutional regulatory and legal aspects and these depend upon the historical, cultural and political situation of a country.

(Anup Agarwal & Charles R. Knoeber, 1996) identify seven mechanisms which control agency problems between managers and shareholders. These include debt policy, shareholdings of insiders, the managerial labor market, institutions, market for corporate control, large block holders and use of outside directors.

(Brick et al., 2005) find whether too much director compensation is associated with weak corporate government structure, excessive CEO compensation and poor performance on the part of the firm. Both compensations including director and CEO can be linked with poor firm performance.

(Sanjai Bhagat & Brian Bolton, 2008) investigate the chain of associations between corporate governance, corporate performance, corporate ownership structure and corporate capital structure. They suggest a governance measure called dollar ownership of the board members. Corporate governance boards have the ability and power to make crucial decisions including management compensation policy, investment policy and board governance.

(Hoque et al., 2011) examine the impact of corporate governance mechanisms on the performance of twenty five banking companies in Bangladesh from 2003 to 2011. Return on assets. Tobin's Q and return on equity are the direct outcomes of public ownership and frequencies of audit committee meetings.

(Jenson et al, 1976) explain the good corporate governance improved economic efficiency and growth, bank performance as well as enhance investor's confidence. If can be argue that good governance will lead to boost firms value as well as better firm performance. Better corporate governance leads to better bank performance.

3. Data & Research Methodology

3.1 Data

In this study the data are selected from two resources. Consolidated annual financial reports of two Islamic and eight conventional banks were selected during the period of 2006 to 2012. The study includes board featured data from each bank site. Therefore, panel data of this study uses ten commercial banks for seven years (70 observations).

3.2 Research Methodology

A pool regression analysis is used to test these two models:

$$\begin{aligned}\boldsymbol{Model\ 1\ ROE} &= b0 + b1BDSZ + b2AUDC + b3CAR + b4CR + b5LLP + b6LDR \\ &+ b7BKSZ + b8OWTP + b9CAR + E\end{aligned}$$

$$\begin{aligned}\boldsymbol{Model\ 2\ ROA} &= b0 + b1BDSZ + b2AUDC + b3CAR + b4CR + b5LLP + b6LDR \\ &+ b7BKSZ + b8OWTP + b9CAR + E\end{aligned}$$

Where,

3.3 Dependent Variables

ROE: this technique is used to check the performance of banking.

ROA: return received on assets invested in organization.

3.4 Independent Variables

CAR: capital adequacy ratio represented by end year capital of the bank divided by end year all risk weighted assets of the bank.

LLP: loan loss provision represented by loan loss divided by end year total loan.

CARSQ: capital adequacy ratio square. Here two control variables are used: bank size & ownership type.

CR: capital ratio

LDR: loan to deposit ratio

3.5 Control Variables

BDSZ: the size of board including number of directors.

AUDC: the audit committee in the board of directors represented by taking dummy variable 1 if not.

BKSZ: the size of bank examined as the yearend total assets log.

OWTP: type of ownership with taking dummy variable 1 if it is state owned bank and 0 if not. This study focuses on both conventional and Islamic banks.

3.6 Research Hypotheses

Two different approaches are needed in order to compare corporate governance of bank and or other business enterprises as the government regulation is higher in banking sector. The hypotheses of this study are:

H1: Bank performance is positively linked with board size and existence of audit committee.

H2: Capital ratio directly influences bank performance.

H3: A positive relationship exists between bank performance and external corporate governance.

4 Results & Discussion

4.1 Descriptive Statistics

Table 1 indicates the descriptive statistics for the research which is based on banking sector listed in KSE in Pakistan for the year 2006 to 2012. The table demonstrates the mean and standard deviation including maximum and minimum value of range. In this table the result shows the comparison of convention, Islamic and total banks respectively mean of audit committee is 0.98, 0.92 and o.99. The convention banks audit committee is larger than Islamic banks. The compression of board size of convention, Islamic and total banks mean respectively 7.73, 10.14 and 8.21, Islamic banks consist more number of board size as compare to total banks.The bank size of convention banks 5.41 is high comparative Islamic banks which bank size is 4.73 and total banks 5.27. The capital adequacy ratio of Islamic banks is 21.38 is grater then convention banks capital adequacy ratio 14.86 and total banks capital adequacy ratio is 16.16. The square of capital adequacy ratio of Islamic banks is 670.77 which is more than the total banks 360.64 and convention banks capital adequacy ratios is 283.11. A total bank capital ratio is 244826 is more than as compared to convention banks 289459 and the Islamic banks capital ratio is 662953. The convention banks have tent to loan on deposits which loan to deposit ratio indicates 0.74 which is high on his competitor Islamic banks which loan to deposit ratio is 0.46 and total banks loan to deposit ratio is 0.68. Islamic banks are risk taker which loan loss provision is 9422.36, convention banks is risk avoider which loan loss provision is 7961.59 and others banks loan loss provision is 8253. Islamic banks are high leverage which ownership type just 0.07, convention banks are low leverage which ownership type 0.12 and total banks ownership type is 0.10. The convention banks have better return on equity 15.93, return on asset 1.41 comparatively Islamic banks return on equity is 9.37 and return on asset 0.59 and total banks return on equity 14.62, return on asset is 1.37.The results of table 1 shoes that the conventional banks audit committee, loan to deposit ratio, loan loss provision, ownership type, return on equity and return on asset are more intensive as compare with Islamic banks.

Table 1: Descriptive Statistics of the Variables

Variable	Convention(N=8)		Islamic(N=2)	
	Mean	Std. Dev	Mean	Std. Dev
AUDC	0.9821	0.13363	0.92857	0.26726
BDSZ	7.7321	2.44570	10.1428	0.66299
BKSZ	5.4123	0.546024	4.73428	0.48898
CAR	14.862	7.970974	21.3828	15.1651
CARSQ	283.10	474.1429	670.776	1046.26
CR	28945	2813532	662953	4328669
LDR	0.7454	0.239927	0.46357	0.14473
LLP	7961.5	7413.835	9422.35	32284.8
OWTP	0.1250	0.333712	0.07142	0.26726
ROE	15.931	13.86052	9.37357	11.0447
ROA	1.4101	1.405939	0.59785	1.06519

Variable	Total sample(N=10)			
	Mean	Std. Dev	Min	Max
AUDC	0.9857	0.11952	0.0000	1.0000
BDSZ	8.2142	2.40707	4.0000	13.0000
BKSZ	5.2767	0.59776	3.5400	6.2000
CAR	16.166	10.0437	4.4200	62.1000
CARSQ	360.64	640.183	19.530	3856.40
CR	244826	267460	5408.8	970295
LDR	0.6891	0.25046	0.2430	1.46000
LLP	8253.7	15509.2	0.0000	121581
OWTP	0.1000	0.30216	0.0000	1.0000
ROE	14.620	13.5314	-50.84	45.0000
ROA	1.2477	1.37712	-5.410	4.35000

4.2 Regression Analysis

4.2.1 Dependent Variable: ROE

Table 2 indicates the impact of independent audit committee, board size, bank size, Capital adequacy ratio, square of capital adequacy ratio, capital ratio, loan to deposit ratio. Loan loss provision & ownership type on the dependent variables return on equity & control variable is Corporate Governance. The demonstrative variable explains very well to dependent variable in the table which R- Square 0.36, adjusted R- Square 0.25, S.E of Regression 11.68 & Durbin-Watson state 0.95. The regression outcomes show the independent variables audit committee, square of capital adequacy ratio& ownership type have the negative & insignificant impact on dependent variables. Board size, capital adequacy ratio, capital ratio, loan to deposit ratio & loan loss provision have a positive & insignificant impact on ROE, but BKSZ have a positive & significant impact on return on equity.

Table 2: Regression Results

Variable	Coefficient	Std. Error	t- statistic	Prob.
AUDC	-9.238174	12.77817	-0.722966	0.4726
BDSZ	1.094466	0.929717	1.177203	0.2438
BKSZ	11.21469	4.098122	2.736543	0.0082
CAR	0.386715	0.684058	0.565325	0.574000
CARSQ	-0.00413	0.010734	-0.38495	0.7017
CR	1.27E-07	9.06E-08	1.403359	0.1658
LDR	4.550431	6.022169	0.755646	0.4529
LLP	3.05E-05	9.67E-05	0.315157	0.7538
OWTP	-11.4402	8.045684	-1.4219	0.1603

R- Square	Adjusted R-Square
0.362475	0.25442
S. E. Regression	Sum squared resid
11.68395	8054.371
Log likelihood	Durbin- waston
-265.417	959653

4.2.2 Dependent Variable: ROA

Table 3 indicates the impact of independent variables audit committee, board size, bank size, Capital adequacy ratio, square of capital adequacy ratio, capital ratio, loan to deposit ratio, Loan loss provision & ownership type on the dependent variables return on asset & the control Variable is corporate governance. The demonstrative variable explain very well To dependent variables on the table which R- Square 0.40, adjusted R- Square 0.30, S.E of regression 1.15 & Durbin- Watson state 1.02. The regression outcome shows the independent variables audit committee, capital adequacy ratio & ownership type have a negative and independent variables. Bank size, capital adequacy ratio, capital ratio, loan to deposit ratio & loan loss provision have a positive but insignificant impact on return on asset, but board size have a positive & significant impact on return on asset

Table 3: Regression Results

Variable	Coefficient	Std. Error	t- statistic	Prob.
AUDC	-1.39125	1.257812	-1.10608	0.2732
BDSZ	0.162791	0.091516	1.778824	0.0804
BKSZ	1.87146	0.403396	2.942878	0.4335
CAR	0.053099	0.001057	0.788582	0.4335
CARSQ	-0.00033	0.001057	-0.31057	0.7572
CR	1.38E-08	8.91E-09	1.546288	0.1274
LDR	0.660831	0.592789	1.114782	0.2695
LLP	7.26E-06	9.52E-06	0.762525	0.4488
OWTP	-0.39089	0.791973	-0.49356	0.6234

R-Square	Adjusted R- Square
0.403614	0.302531
S.E. of Regression	Sum squared resid
1.150104	78.04156

Log likelihood	Durbin- Watson stat
-103.132	1.025808

5. Conclusion

The results of table indicate that capital adequacy ratio has a positive relationship with bank performance. The impact of capital adequacy ratio & return on equity is the positive and insignificant but the bank size (assets of banks) has a positive and significant impact on return on equity, where the financial position of bank improves. Board size, capital ratio, loan to deposit ratio & loan loss provision also have a positive and significant impact on bank performance, but on the other hand audit committee, square of capital adequacy ratio & ownership type have the negative & insignificant impact which decrease the performance & effect the profitability of the investors.

The independent variables bank size, capital adequacy ratio, capital ratio, loan to deposit ratio& loan loss provision have a positive impact on return on asset, which increased the firm performance & board size have a major impact enhance the bank profitability, but on the other hand audit committee, square of capital adequacy ratio & ownership type have a negative impact on firm performance. Thus the overall corporate governance has a major impact to enhance the bank performance and to increase the profitability and confidence of investors.

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