Does Effective Corporate Governance Enhance the Financial Performance of Banks?

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ABSTRACT

This study has been conducted to find out the relationship between corporate governance practices and the performance of banks. Corporate governance provides a structure to control and direct the organizations or banks. Theoretically, it is said that corporate governance practices improve the performance of the banks. This study reveals the same facts, the majority of the factors affect the performance of the banks. The independent variables of this study are Transparency, Independence, Ownership structure, Audit committee, BOD, and CEO duality. This study is based on primary data, questionnaires were developed and distributed to top officials of banks. Results indicate that all independent variables have a significant impact on the performance of banks except one variable which is transparency. Regulatory bodies should play their roles in the implementation of corporate governance practices on banks because it improves the overall performance of the banks. This study is useful for policymakers dealing with corporate governance practices and indicating the important variables affecting the performance of banks. This study is based on primary data, in future secondary data can also be used, or mixed methods can be used for future studies.

Keywords: *Governance; Ownership Structure; CEO Duality; Corporate Governance Practices.*

INTRODUCTION

In developed countries, corporate governance is an extremely popular and well-explored area that contributes a lot to the betterment of a firm's performance and ultimately it positively affects the overall economy. In developing countries, this phenomenon is getting popular day by day. Corporate governance has become a focal point of consideration in today's business arena. This is true because of the vast number of partners whose stakes & premiums are in

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question within the business, they want to keep their interests intact, and it is only possible if there is an effective corporate governance system in place. If there is no sound corporate governance, business cannot endure. According to the agency theory, directors of firms have their own interests, and they are more concerned about their funds rather than the money invested by the shareholders (Letza, 2004). Agency theory also states that the primary objective of corporate governance practices is to ensure that managers and directors are working to protect the interests of corporate owners. (Shleifer & Vishny, 1997). According to stakeholders' theory, there should be a balance among the rights and responsibilities of various stakeholders. (Abrams, 1951) John and Senbet (1998) also discussed the stakeholder theory and described that stakeholders have competing goals in the organization and there should be a balance between these goals. According to La Porta et al. (2000), it is a set of mechanisms by which those who are outsiders are protected and safeguarded from the exploitation of insiders. Corporate governance is a mechanism through which organizations are controlled and directed. The structure of corporate governance describes the rights and responsibilities of the different stakeholders of the corporations, like board directors, chief finance officers, external and internal auditors, shareholders, managers, and other stakeholders, and also discusses the rules in corporate affairs. Owusu and Weir (2016) found that CGPs are the basis of corporate structure and provide guidelines and directions to organizations. It describes the relationship between the roles of its board of directors, roles of its employees, the control system of the company, roles of auditors, shareholders, and other stakeholders. Corporate governance extensively refers to the systems, procedures & relations through which organizations are controlled and coordinated. A weak mechanism of corporate governance is destructive for the corporations and most organizations collapse due to the absence of a strong corporate governance system. Therefore, there is a need to have a strong governance system, and it also reduces the chances of fraud in organizations (Berkman et al., 2009). The failure to have a good governance system affects the overall performance of the firm. (Sun et al., 2011). If there is no sound corporate governance, a business can't endure. Corporate governance ensures the smooth sailing of a business and deviations from the said practices severely affect the performance of the firm (Erick Rading Outa Nelson M. Waweru, 2016).

LITERATURE REVIEW

Theoretical Exposition of Corporate Governance

According to the agency theory, directors of firms have their own interests, and they are more concerned about their funds rather than the money invested by the shareholders (Letza, 2004).

Agency theory also states that the primary objective of corporate governance practices is to ensure that managers and directors are working to protect the interests of corporate owners. (Shleifer & Vishny, 1997). According to stakeholder theory, there should be a balance between the rights and responsibilities of various stakeholders (Abrams, 1951). John and Senbet (1998) also discussed the stakeholder theory and described that stakeholders have competing goals in the organization and there should be a balance in these goals.

Transparency and Accountability

Zambia (2005) found in their study that most of the Asian business lack transparency. Because of a lack of transparency, these businesses are more prone to fraud and embezzlement of cash. SEC Manual of Corporate Governance (2002) emphasizes the significance of transparency. It is one of the most important characteristics of corporate governance. Transparency can be found and applied with the help of three elements: Accounting Standards, Compliance reporting, and openness. The efficiency and profitability of the business depend upon the trust and confidence of investors, creditors, and other stakeholders, and trust can only be developed if all stakeholders are satisfied with the correctness and availability of information to the public. Ananchotikul (2008), Black et al. (2003), Klapper and Love (2002), and Khanna et al. (2001) have discussed transparency. Transparency in recording is very important for good corporate governance. This enhances the confidence of investors and other stakeholders in the firm. They also discussed the importance of accountability with transparency. Ananchotikul (2008), Black et al. (2003), Klapper and Love (2002), and Khanna et al. (2001) have found that accountability is also important for good corporate governance. Mwanakatwe (2005) found that corporate governance is very important in the banking sector because it keeps the funds of the public and therefore, they are more responsible and accountable. He also pointed out that banks are the backbone of the financial sector, and this sector also contributes towards economic development, therefore it is again necessary to make them more accountable. Zun (2002) found in his research that companies belonging to Taiwan lack transparency in their financial reporting and there was an element of bias in reporting which severely affects the corporate governance practices of those firms.

Independence

Miles (2010) indicated that Anglo American model guides the corporate governance mechanism. It talks about the association ship between shareholders and directors. In order to overcome the problems of corporate governance, particularly concerning the benefits of directors concerned to the shareholders. Anglo American model focuses and emphasizes on the

supreme independence of directors because directors are just like the eyes and ears of corporate owners. Independence and objectivity in internal communication are also very significant. Independence is also important because the board of directors is liable for various integral duties of the company. Deakin (2005) indicated that the role of independence has become very vital in corporate governance. They further described that independence in the powers connected with directors, managers, and majority and minority shareholders is very important. Good governance produces good results and output. Governance with independence is important but it must be assured by accountability.

Ownership Concentration and Structure

Agency theory talks about ownership concentration. Agency theory says that dispersed ownership reduces agency cost and more disclosure of information for different stakeholders, while concentrated ownership increases the agency cost and reduces disclosure of information for shareholders. Santiago-Castro (2005) discovered that agency problems occur due to the mismanagement and misalignment of interests among several types of stockholders such as majority and minority stockholders. Claessens et al. (2000, 2002) discovered the same problem in East Asian countries where there is a conflict of interest between the majority and minority corporate owners. La Porta et al. (2000) defined that the agency problem is nothing else but conflict among inside shareholders and outside shareholders. At the time of preparation of the company's policies, shareholders had the majority stake in the ownership and influence on the policy-making decisions. Information asymmetry exists in developing countries because of concentrated ownership and it weakens the corporate governance. (Berghe, 2002; Rashid, 2008). Weakness or absence of a high level of regulations. To alleviate this problem, directors and managers need to disclose voluntary information that is not regulated (Nelson, 2007). Poor managerial performance. This is because such managers try to hide information from shareholders so that they do not detect their deficient performance (Dallas, 2004). The concentration of ownership is in the hands of a few shareholders. This information asymmetry is particularly prevalent in developing countries where corporate governance as a monitoring system tends to be weak (Berghe, 2002; Rashid, 2008). There is a need to disclose information that is not regulated and hide that information, which creates unrest among shareholders. (Nelson, 2007). Lemmon and Lins (2003), pointed out that during the financial crisis in 1997, the listed companies in Korea which had higher levels of inside ownership great fall in the value of their stocks. He said that there was a negative correlation between inside ownership and the performance of the company. Baek et al. (2004), also observed a greater fall in the

value of stocks during the financial crisis in 1997, where the inside ownership was at a higher level. Salami (2011) found in his research that the concentrated ownership of external shareholders creates an impact on profitability of the company because the external shareholders had gained voting power due to the concentrated ownership. He observed in his research that those companies that have a low level of concentrated ownership by external shareholders showed lower profitability of the company. Sorensen (2007) observed that the impact created on the company's profitability due to the dispersion of ownership. He found that those companies that had dispersion ownership suffered losses, so there was a negative relation with the performance of the companies.

CEO-Duality

CEO-duality is when a person is chairperson of the board of directors of the company and also holds the position of CEO. A lot of power in the hands of one individual driving the choices that would not support the enthusiasm of shareholders. Rechner and Dalton (1991) found through their research that there was an impact on company performance due to the changing of the board of directors. They found due to the changing of board directors in the company, there was a difference in the return on equity (ROE), profit margin, and return on investment (ROI) of the companies that have independent directors as compared to those companies that have CEO-duality. Sanda et al. (2011) found that there was a positive relationship when the CEO and chairman had separate positions. Faleye (2007) took a sample of 2166 companies in the United States and observed whether the structure of board leadership relies on the characteristics of the individual firm or not. He found that the firms that have complex operations, sound CEO reputation, and alternative control mechanisms should have CEO-duality status in those firms.

Board of Directors

Jensen and Meckling (1976), found through their research that a higher concentration of shareholders creates a negative impact on the performance of the company because of the higher concentration of shareholders gives enough benefits, power, and control to the top managers of the company and may create other types of cost. According to Jesen and Fama (1993), they observed from their research that the internal control system of the firm is the most important governance mechanism. The structure of the board had trusted the concept of the control function of the board. They said that the assets of the company were the property of the shareholders or owners of the company and these assets of the company were used by the managers of the company, so for the check and balance of the assets and activities of the

managers installing the board of directors because they were the effective tool for monitoring the top managers of the company, there was a positive impact on the performance of the company and increases the trust of the shareholders. According to Jensen (1993), told that from his study the board of the company represents the internal mechanism of the company. The board helped the managers of the company to align their interests with the shareholders of the company then managers worked hard to increase the market value of the company. There was a positive link between the board and the performance of the company. According to Dalton and Daily (1999); Lorsch (1995); and Westphal (1999), they said that the main work for directors is to give proficient views and tactical advice to the CEO of the company to get a competitive advantage and there was a positive link between board of directors and performance of the company. According to La Porta et al. (1999), Villalonga and Amit (2006), observed from studies that the shareholders who have control of the company, use their power and they can use the power to acquire private profit creating a negative impact on the company performance. According to Jackling and Johl (2009), told that the role of the board of directors plays an important role in the performance of the firm.

Audit Committee

Klien (2002) used multiple measures of independence and observed the relationship between the independent audit committee and the performance of the companies. She extracted from his studies that firms with majority independent members of the audit committee impacted positively on the performance of the company, but in his study did not hold fully independent of the audit committee. Bédard et al. (2004) also used multiple levels of independence; anir study showed a positive link between the independent audit committee and the performance of the company. Islam et al. (2010) argued that an independent audit committee was a very important mechanism. This type of committee was very helpful for those users who needed financial statements, and the previous research explained that this type of committee maintained the excellence and integrity of the financial reporting process of the firm. While some studies support that there is a negative relationship between the independent directors on the audit committee, 100 percent of independent directors did not observe a significant impact on the audit committees' independence. Nguyen and Nielsen (2010) said that usually independent directors provide their expertise and abilities in large companies, and they caution that his prestige, committee should include an independent board of directors. Siagian and Tresnaningsih (2011) audit committees would be independent from the management of the firm, which should improve the quality of reported earnings and the reporting system of the

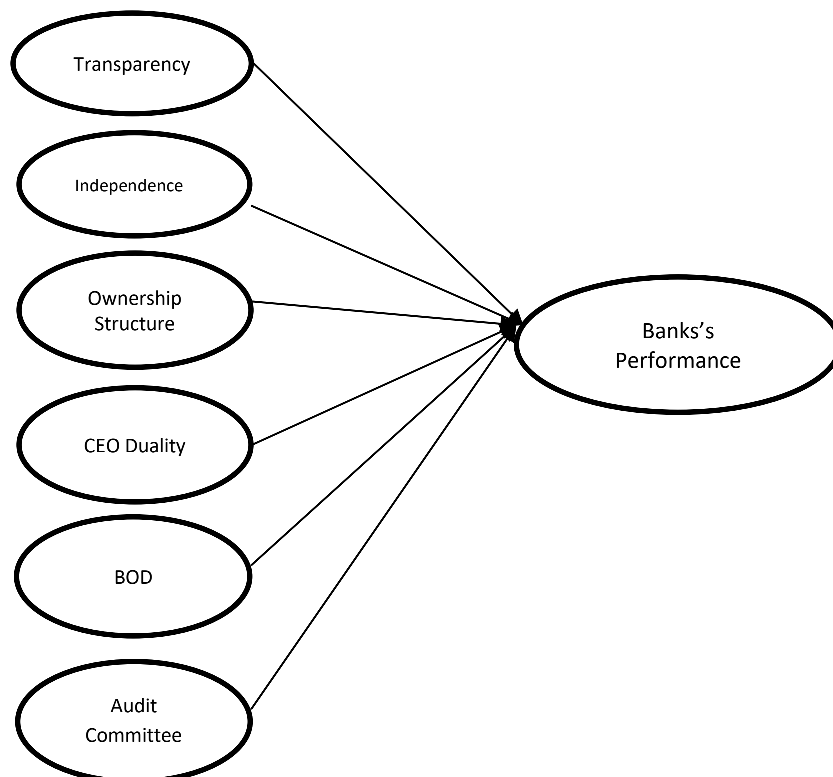
firm. Carcello and Neal (2000) found in their research that those companies that were not performing well did not have independent audit committees and they further argued that the existence of independent audit committees handles the pressure of management in an efficient manner and releases the pressure of auditors to issue the clean report about going concern of an entity.

Vein and Klein (2002a) discussed in their study that the independent role of the audit committee depends on the independence of the board and there is a positive relationship between the independence of the board and the independent audit committee.

Corporate Governance and Performance

Thomsen (2005) found in his research that there is a definite relationship between corporate governance practices and the performance of firms. He also said an efficient and effective system of governance improves the performance of firms and reduces the chances of fraud and other unfair practices. Black et al. (2006) found the same result that corporate governance practices and performance are quite interrelated. It means that good corporate governance positively affects the performance of the firm. Qi et al. (2000) analyzed the effectiveness of full disclosure of information from the point of view of shareholders and found that full disclosure of information positively affects the performance of the firm.

CONCEPTUAL FRAMEWORK



RESEARCH METHODOLOGY

Population

This study is quantitative in nature. The population of this study is staff working in senior managerial positions at head offices of HBL, ABL, MCB, UBL, and Faisal Bank located in Karachi.

Sampling Techniques

Quota sampling was used. From each bank, 10 questionnaires were collected for pilot testing. 20 questionnaires would be collected from each of the five banks for the full study.

Data Collection Tool

A questionnaire was used to collect the data. The questionnaire was developed on the Likert Scale. In the initial stage, there were some questions about the demographic information of respondents and then most of the questions were based on the independent variables and there were some questions about independent variables.

Pilot Testing

Pilot testing of the questionnaire was done by sending 20 questionnaires to five banks. Four questionnaires were sent to each of the selected banks.

DATA ANALYSIS

Table 1. Reliability Statistics

Cronbach's Alpha	N of Items
.770	27

The above table indicates that the data is reliable because Cronbach's Alpha is .77 which is more than 0.6. It means the data is reliable and further tests can be applied on the data.

Table 2. Correlation Analysis

		Transparency	Performance
Transparency	Pearson Correlation	1	.095
	Sig. (2-tailed)		.418
	N	75	75
Performance	Pearson Correlation	.095	1
	Sig. (2-tailed)	.418	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 1:

H_0: *There is no positive relationship between* transparency and the performance of banks.

H_1: *There is a positive relationship between* transparency and the performance of banks.

The null hypothesis is not rejected because the p-value is not significant at 0.000.

Table 3. Correlation Analysis

		Independence	Performance
Independence	Pearson Correlation	1	.537**
	Sig. (2-tailed)		.000
	N	75	75
Performance	Pearson Correlation	.537**	1
	Sig. (2-tailed)	.000	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 2:

H_0: *There is no positive relationship between independence and the performance of banks.*

H_1: *There is a positive relationship between independence and the performance of banks.*

The null hypothesis is rejected because the p-value is significant at 0.000.

Table 4. Correlation Analysis

		Audit Committee	**Performance**
Audit Committee	Pearson Correlation	1	.476**
	Sig. (2-tailed)		.000
	N	75	75
Performance	Pearson Correlation	.476**	1
	Sig. (2-tailed)	.000	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 3:

H_0: *There is no positive relationship between the audit committee and the performance of banks.*

H_1: *There is a positive relationship between the audit committee and the performance of banks.*

The null hypothesis is rejected because the p-value is significant at 0.000.

Table 5. Correlation Analysis

		Performance	**Ownership**
Performance	Pearson Correlation	1	.461**
	Sig. (2-tailed)		.000
	N	75	75
Ownership	Pearson Correlation	.461**	1
	Sig. (2-tailed)	.000	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 4:

H_0: *There is no positive relationship between the ownership structure and the performance of banks.*

H_1: There is a positive relationship between the ownership structure and the performance of banks.

The null hypothesis is rejected because the p-value is significant at 0.000.

Table 6. Correlation Analysis

		Performance	BOD
Performance	Pearson Correlation	1	.382**
	Sig. (2-tailed)		.001
	N	75	75
BOD	Pearson Correlation	.382**	1
	Sig. (2-tailed)	.001	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 5:

H_0: There is no positive relationship between BOD and the performance of banks.

H_1: There is a positive relationship between BOD Duality and the performance of banks.

The null hypothesis is rejected because the p-value is significant at 0.000.

Table 7. Correlation Analysis

		Performance	**CEO Duality**
Performance	Pearson Correlation	1	.307**
	Sig. (2-tailed)		.007
	N	75	75
CEO Duality	Pearson Correlation	.307**	1
	Sig. (2-tailed)	.007	
	N	75	75

***. Correlation is significant at the 0.01 level (2-tailed).*

Hypothesis 6:

H_0: There is no positive relationship between CEO- Duality and firm performance.

H_1: There is a positive relationship between CEO- Duality and firm performance.

The null hypothesis is rejected because the p-value is significant at 0.000.

Regression Analysis

Table 8. Model Summary

Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of Estimate**
1	.630[a]	.397	.344	.46779

DISCUSSION

In this study, there are six independent variables and one dependent variable. According to the results, one independent variable, which is transparency, does not have any impact on the performance of the firm. This result is quite surprising because previous studies explain that transparency does affect the performance of the banks. There is a very weak correlation between transparency and the performance of the banks, which is .095. The hypothesis of no

correlation between transparency and performance would not be rejected because the p-value is more than the significant value. P value is .46. Independence has the highest correlation or association ship with the performance of the banks. The correlation between independence and performance is .537. It has a significant impact on the performance of the banks. Ownership structure also has a correlation or association ship with the performance of the banks. The correlation between ownership structure and performance is .461. Ownership structure also has a significant impact on the performance of the banks. BOD also has a correlation or association with the performance of the banks. This relationship is weak. The correlation between BOD and performance is .382. BOD also has a significant impact on the performance of the banks. CEO duality also has a correlation or association ship with the performance of the banks. This relationship is weak. The correlation between CEO duality and performance is .307. The correlation between the BOD and the performance of the banks is low. CEO duality also has a significant impact on the performance of the banks. The audit committee also has a correlation or association ship with the performance of the banks. This relation is weak. The correlation between the Audit Committee's effectiveness and performance is .476. The correlation between the Audit Committee and the performance of the banks is low. The Audit Committee also has a significant impact on the performance of the banks.

CONCLUSION AND FUTURE DIRECTIONS

This study was conducted to find out the relationship between corporate governance practices and the performance of banks. Corporate governance provides a structure to control and direct the organizations or banks. Theoretically, it is said that corporate governance practices improve the performance of the banks. This study reveals the same facts, the majority of the factors affect the performance of the banks. The independent variables of this study are Transparency, Independence, Ownership structure, Audit committee, BOD, and CEO duality. This study is based on primary data, five banks were selected for conducting a survey, and fifteen forms were collected from top officials of each bank. Results indicate that all independent variables have a significant impact on the performance of banks except one variable which is transparency. Regulatory bodies should play their roles in the implementation of corporate governance practices on banks because it improves the overall performance of the banks. In the future, the influence of government ownership can be examined on corporate governance practices and ultimately how it impacts the performance of the banks. In the future, mixed methods can be used to analyze the data, this study is based on primary data only. In the future, the Composition of the board, the remuneration committee, and the size of the board can also

be included as independent variables. In the future, the study can also be conducted by moderating variables as well.

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