Abstract

This paper investigates the effect of corporate governance mechanisms on performance of commercial banks in Bangladesh. To conduct the study, four hypotheses have been developed. In order to test the hypotheses, 140 observations are collected by taking 14 sample banks for a period of 10 years ranging from 2006 to 2015. In this paper, four corporate governance tools such as Board Size, Board Independence, Internal Audit Committee Members and Capital Adequacy Ratio are taken as independent variables and Return on Asset, Return on Equity and Earnings per share are taken as dependent variable to measure bank performance. Correlation Analysis and Multiple regressions are used to examine the hypotheses in this study. The result shows that Board size, number of independent directors and number of internal audit committee members are inversely related to bank performance. Regression results also shows there is a linear relation exists between capital adequacy ratio and return on asset but non linear relation between CAR and other two performance measures return on equity and earnings per share. It may be due to Bangladesh Banks' regulations to maintain 8% CAR level to protect depositors' interest which is very nominal. If CAR reaches to such level in which depositors will start to believe that bank is capable enough to face any unexpected situation, therefore, implementing better corporate governance. It will lead a bank to get more deposits and investment. This study provides useful information in increasing understanding on the relationship between corporate governance practices and bank performance. The study also reveals that policymakers, regulators, owners and stakeholders should focus more on effectiveness and efficiency of respective board members rather than number.

Keywords: Corporate governance, Board size, Board Independence, Members of Internal Audit Committee, Capital Adequacy Ratio, Bank Performance.
1. Introduction:

The concept of Corporate Governance is not new rather it arose with the birth of corporations. But the concept has received significant attention after the collapse of few giant firms named Enron Corporation, Tyco and World Co. There are a considerable research conducted on corporate governance within the developed countries context but in emerging economy still there is a dearth of study in this regard (Shleifer and Vishny, 1997; Denis and McConnel, 2005). Several structural changes such as the introduction of the Sarbanes-Oxley Act, 2002 in the United States have been adopted to prevent such events happening in the developed markets context but such reactions are almost absent in developing countries. Therefore, this study attempts to reduce the dearth of literatures on corporate governance in emerging economies like Bangladesh.

Banking sector of Bangladesh has been brought under criticism due to some recent financial scam. For instance, BDT 4000 crore loan scam of Hallmark Group, BDT 200 crore loan scam of Bismillah Group where six commercial banks were involved. Such fraudulent activities actually indicate lack of corporate governance practices in the banks. Banking sector portrays the whole economy of a country. Recent financial crisis has highlighted the needs of Corporate Governance to restore trust in banking industry of Bangladesh. In fact, needs for corporate governance arises due to potential conflict of interest among stakeholders. Such conflict results from stakeholders’ imperfect information of each other’s actions and preference (Osman, 2006). Good corporate governance helps to realize value and gain competitive advantage that has a positive impact on firm performance. There have been many studies carried out to determine whether there is a link between corporate governance and bank’s performance, the evidences appear to be fairly mix. Therefore, the study aims at investigating the impact of corporate governance on public listed banks in Bangladesh.

This paper is divided into 6 sections. The section 2 and 3 discuss literature review and conceptual framework, respectively. Section 4 focuses on methodology of the study and section 5 discusses analysis of the result and findings of the study. Section 6 shows conclusion and managerial implications regarding the issues followed by scope for further research.

2. Theoretical Discussion and Hypotheses Development:

2.1. Corporate Governance:

Corporate governance is a blend of some policies, procedures, customs, laws, and institutions affecting the way a corporation is directed and controlled with a view to enhance business prosperity with corporate accountability. Good corporate governance is basically aimed at minimizing agency conflict (Bozec and Bozec, 2007). Corporate governance of banks could be different from corporate governance of other business enterprises due to the existence of depositors in addition to shareholders, and high government regulation in banks. It is thus suggest that a broader perspective of corporate governance needs to be implemented in the case of banks. Bank corporate governance involves internal and external corporate governance mechanisms. Internal corporate governance mechanisms include board size, board independence and no. of board of directors (Zabri et al, 2015). On the other hand, external corporate governance mechanisms include but not limited to competitive market conditions, the market for managerial labor, talent and market for corporate control and the government regulations and supervisions (Zabri et al, 2015). In this study, some of the most influential internal indicators of corporate governance were used which are Board Size, Board Independence, no. of Board meetings, Audit committee, capital adequacy ratio. These indicators are explained in the following subsections.

2.1.1 Board Size: Board size represents number of directors on a board. There are mixed feelings regarding size of the 'ideal' board. An ideal board should consist of both executive and non-executive directors (Goshi et al., 2002). Lipton and Lorsch (1992) preferred eight to nine persons on board while Leblanc and Gillies (2003) claimed that members of board should be eight to eleven. BEI (2004) guidelines state that internationally successful corporate boards have memberships of 7 to 15 directors and according to BSEC (2012) the number of the Board Members of the company shall not be less than 5 (five) and more than 20. In reality, the effective board size should be consists of diverse expertise and experience to ensure a well-functioning board. Boards having too many directors could be unproductive with ineffective communication that results directors free riding problem. Rather than number, effectiveness of board should be the utmost consideration.
2.1.2 Board Independence: Board independence means composition of independent directors to total number of directors (Prabowo and Simpson, 2011). Presence of independent directors enables the board to take neutral and unbiased decision. One of the conditions of the BSEC (2012) is that at least one fifth (1/5) of the total number of directors in the company's Board shall be independent. Thus board of directors is more independent with the increase of independent directors (John and Senbet, 2008).

2.1.3 Audit Committee: The Audit Committee reviews internal financial operations, improves the integrity of financial statements, and recommends appointment of external auditors and monitors auditor independence and objectivity and audit effectiveness that helps a firm to achieve its goals in an effective and efficient way (Stewart and Subramaniam, 2013). The main objective of establishing an Audit committee is to uphold the integrity of financial statements by reflecting economic substance of transactions and present a true and fair view (Ojo, 2006). Internal audit assists management and the board of directors in the effective performance of their responsibility (Lorsch and Young 1990). Audit committee contributes a lot in decision making of Board of Directors, management, internal audit and external audit.

2.1.4 Capital Adequacy Ratio (CAR) One of the most important indicators of implementation of good governance practice is capital adequacy ratio (minimum statutory requirement) that portrays long time survival capacity of business. It also reduces the chances of banks becoming insolvent (Yudistira, 2003) It is used to protect depositors and promote the stability and efficiency of financial systems around the world. Bank can provide protection and confer confidence of its depositors and creditors by ensuring bank's capital adequacy to absorb losses and financial short comings.

2.2 Bank’s Performance:

Good corporate governance tends to ensure sound corporate performance by providing protection for shareholders interest (OECD, 2004). Investors and lenders will be more willing to put their money in firms with good governance because they will face lower costs of capital, which is another source of better firm performance (Coombes and Watson 2000). Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and long lasting than those with firms with less effective governance.

Many previous studies use ROA (Brick et al., 2006; Cheng, 2008; Jackling and Johl, 2009; Brown and Caylor, 2005; Klein, 1998) ROE and EPS (Lo, 2003) as their firm performance measures. ROA represents the actual performance (Ponnu, 2008). ROE, another reliable performance measure for stakeholders (Johnson and Greening, 1999) and it is suitable both in short-term and long-term for most investors (Brealey and Myers, 2000). It shows an investor how much profit can be generated by the firm, using the money invested from its shareholders (Epps and Cereola, 2008). EPS enable the stakeholders to know net income earned on per share basis which helps to determine profitability (Weygant et al, 2010).

The study uses ROA, ROE and EPS to measure performance of banks.

2.3 Relationship between Corporate Governance Practices and Bank Performances

2.3.1 Relationship between Board size and Bank Performance: Although board size is one of the important mechanisms of good corporate governance but there is a mixed opinion among researchers regarding size of the board and bank performance. Some researchers say that there is a negative relationship between board size and bank performance (Mishra et al., 2001; Singh and Davidson, 2003, Holthauson and Larcker, 1993), where as other researchers suggest that there is a positive relation between board size and bank performance (Shukeri et al., 2012; Adam and Mehran, 2003; Mak and Kusnadi, 2005; Kiel and Nicholson, 2003). It is because, in a situation where board size is small, their likeminded persons are appointed as directors and abuse the rights of minor shareholders. Again, some researchers found that bank performance is unaffected by size of the board (Holthauson and Larcker, 1993). This findings is also supported by Forbes and Milliken, (1999).
2.3.2 Relationship between Board independence and Bank performance: One of the conditions of the BSEC (2012) is that at least one fifth (1/5) of the total number of directors in the company’s Board shall be independent. Presence of independent directors in board can bring independence in decision and able to eradicate agency problem and curb managerial self-interest (Abdullah, 2004; Rhodes et al., 2000). Therefore, mass shareholders interest can be protected. Board independence is negatively related to bank performance (Chen et al., 2006; Conger and Lawler, 2009; Haniffa and Hudaib, 2006). Again, Ramdani and Witteloostuijn, 2009, Zubaidah et al. 2009, Rhodes et al., 2010) stated that the result for relationship between board independence and firm performance are mixed. Dehaene et al. (2001) unveiled that a proportion of independent directors are positively correlated with ROE among Belgian companies. This finding is supported by Byrd et al. (2010) as he pointed out a significant positive effect of independent directors on firm performance. Ramdani and Witteloostuijn (2009) claimed that board independence only has an effect on firms with average performance; firms with below average performance are not affected. On the other hand, Chen et al. (2006) claimed that the percentage of independent directors on boards has little impact on overall firm performance. Inversely, research by Hermalin and Weisbach (2001) found no evidence that board independence affects firm performance. This result was consistent with another study conducted by Klein et al. (2005).

2.3.3 Relationship between Internal Audit Committee and Bank Performances: Many of the internal auditors suggest that there is a correlation between internal audit function and firm’s performance. A group of researchers suggest that the audit committee plays a large role in consolidation of financial control within a company (Vinten and Lee, 1993). Audit committees help to figure out appearance of errors in earnings management, which otherwise may lead to inaccurate financial statements (Defond and Jiambalvo, 1991; Peasnell et al., 2000). The effective internal audit can also safeguard the firm from potential losses and increase level of shareholders value (Awdat, 2015). Internal audit tends to achieve better returns by improving higher firm performance (Feizizadeh, 2012).

2.3.4 Relationship between Capital Adequacy Ratio and Bank Performances: In the banking industry, capital is usually regulated by an apex bank to mitigate bank solvency problems (Bernauer and Koubi, 2002). Customers are more concerned with the sufficiency of banks’ capital for the safety of their deposits. Capital adequacy ratio helps a bank to absorb its realized and anticipated losses (risk) and improve their return on capital.

2.4 Conceptual Framework:

The main objective of this study is to show the impact of Corporate Governance on Performance of banks in Bangladesh. Corporate governance factors that are used in this study are Board Size of the respective banks (BDSZ), Board Independence (BIND), Size of Internal Audit Committee in the board (AUDC) and Capital adequacy ratio (CAR) as independent variables and Earnings Per Share (EPS), Return on Asset (ROA) and Return on Equity (ROE) are taken as dependent variables to measure bank performance.

The following are hypotheses developed to be tested in this study:

H1: There is a relationship between Board size and Bank Performance.

H2: There is a relationship between Board Independence and Bank Performance.

H3: There is a relationship between size of Internal Audit Committee and Bank Performance.

H4: There is a relationship between Capital Adequacy ratio and Bank Performance.

3. Methodology of the Study:

This study is relying on quantitative design. The evaluation and assessment of the bank performance is according to the secondary data gathered from the company’s annual report.

3.1 Sample and Data Collection Procedures:

The population of the report is all banks operating in Bangladesh. The time frame considered for the study is 10 years. Among the population, fourteen banks are taken as sample to analyze the impact of corporate governance on performance of banks. These fourteen sample banks are Trust Bank Limited, South East Bank Limited, AB Bank Limited, City Bank Limited, Dhaka Bank Limited, Islami Bank Limited, IPIC Bank Limited, EXIM Bank Limited, Mercantile Bank Limited, Janata Bank Limited, First Security Islami Bank Limited, Premier Bank Limited, Dutch Bangla Bank Limited, United Commercial Bank Limited. The annual
4. Analysis of the Data and Findings of the Study

Correlation coefficients reveal the strength of the relationship between two variables and the direction (positive and negative). It can range from -1.00 (a perfect negative value) to +1.00 (a perfect positive value). It can be justified that there is no relationship between the variables being tested if the value is 0.00. Bank Performance is measured by three dependent variables; EPS, ROA and ROE. For hypothesis 1 (relationship between Board Size and Bank Performance), the correlation coefficient of Board size and EPS was -0.223 and significance value of P = .008 was less than 0.05, this means that board size is inversely proportional to bank’s EPS. Larger size of the board causes lower EPS. But correlation coefficient is -.029 and -.114 for ROA and ROE respectively. It means there is also a negative correlation exists between Board size and ROA and ROE. Size and these two performance indicators (ROA and ROE) and significance value of P = .730 and .181 respectively, which is more than .05. Thus Ho is accepted. It can be concluded that there is no relationship between Board size and ROA and Board size and ROE. For hypothesis 2 (relationship between independence and Bank Performance) the correlation coefficient of Board Independence and EPS is -.452 and significance value of P = .000, this means there is a high negative correlation exists between Board Independence and EPS. It means there is also a negative correlation exists between Board size and ROA and ROE. Size and these two performance indicators (ROA and ROE) and significance value of P = .730 and .181 respectively, which is more than .05. Thus Ho is accepted. It can be concluded that there is no relationship between Board size and ROA and Board size and ROE. For hypothesis 3 (relationship between reports of selected banks are examined after downloaded from the respective banks’ official web sites. The reason for choosing annual reports is that annual report is the most widespread and accepted document produced regularly by the companies in Bangladesh. Belal (1999, 2000) and Khan et al. (2009) illustrated that annual reports are considered as the major means through which information about the company is communicated. The construction of variables and their measurement technique are elaborated in following table:

3.2 Model specification:
In this report three regression models are used to understand the impact of corporate governance on performance of banks. The models are:

1. Model 1 EPS = a0 + a1BDSZ + a2BIND + a3AUDC + a4CAR + E
2. Model 2 ROA = a0 + a1BDSZ + a2BIND + a3AUDC + a4CAR + E
3. Model 3 ROE = a0 + a1BDSZ + a2BIND + a3AUDC + a4CAR + E

To measure the impact of corporate governance on performance of banks at first the author have developed some hypotheses and to prove the hypotheses author formulate the above three models where Earnings per share (EPS), Return on Asset (ROA) and Return on Equity (ROE) are taken as dependent variables and Board Size of the respective banks (BSZ), Size of Internal Audit Committee (AUDC) and Capital adequacy ratio (CAR) are taken as independent variables. a0 is the constant and E represent the error term.

3.3 Data Analysis Method:
Statistical Package for Social Sciences (SPSS) is used to assess and analyze the collected data to examine the relationship between corporate governance practices and firm performance. There are two methods of analysis used in this study, which are correlation and regression analysis. These methods are used to examine the relationship between dependent and independent variables. Finally based on panel data regression analysis a suitable conclusion is drawn and some managerial implications are suggested.
The negative values of correlation coefficient with EPS (-0.416) and with ROA (-0.181) and with ROE (-0.305) (indicated that there is a negative correlation exists between number of members in audit committee and bank performance (measured by EPS, ROA and ROE) and significance value of P. (EPS = .000; ROA = .032, ROE = .000). Therefore, H3 is accepted. It means there is an inverse relationship between members of audit committee and bank performance. The negative effect of internal audit committee on bank performance could be attributed to the audit committee members’ lack of expertise in helping the board in the governance of the bank. For hypothesis 4 (relationship between capital adequacy ratio and Bank Performance), the negative values of correlation coefficient with EPS (-0.079) and with ROA (-0.038) and with ROE (-0.087) (indicated that there is a negative correlation exists between CAR and Bank Performance (measured by EPS, ROA and ROE) and significance value of P. (EPS = .352; ROA = .658, ROE = .309). Therefore, H0 is accepted. It means there no relationship between capital adequacy ratio and bank performance.

The multiple regression results of the study are presented in table 4.3 for model 1. The regression output in Table 4.3 is run by taking EPS as a dependent variable. The regression output reveals that the dependent variable is explained by the explanatory variables in the model with R-square and adjusted R-square of 11.4% and 8% respectively. The F-statistic of 4.356 is also significant with P-value of .002, suggesting that corporate governance has an impact on ROA. From Table , it is seen that there is a negative relationship between Board Independence and ROA, and a positive relationship between capital adequacy ratio and ROA. Board size and Audit committee has no relation with ROA.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>70.380</td>
<td>23.499</td>
<td>2.995</td>
<td>.003</td>
</tr>
<tr>
<td>Board Size</td>
<td>-1.345</td>
<td>.690</td>
<td>-.160</td>
<td>1.949</td>
</tr>
<tr>
<td>Board Independence</td>
<td>-4.397</td>
<td>1.997</td>
<td>-.196</td>
<td>2.201</td>
</tr>
<tr>
<td>Capital Adequacy Ratio</td>
<td>-4.10</td>
<td>1.761</td>
<td>-.019</td>
<td>-.233</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>-5.778</td>
<td>2.737</td>
<td>-.190</td>
<td>-2.111</td>
</tr>
</tbody>
</table>

**Table 4.3: Regression Analysis**

In Table 4.4, the regression is run by taking ROE as a dependent variable. The regression output reveals that the dependent variable is explained by the explanatory variables in the model with R-square and adjusted R-square of 7% and 4% respectively. The F-statistic of 2.557 is also significant with P-value of .042, suggesting that corporate governance has an impact on ROE. It is seen that there is a negative relationship between Audit committee and ROE, and other independent variables have no effect on ROE.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>19.837</td>
<td>6.401</td>
<td>3.099</td>
<td>.002</td>
</tr>
<tr>
<td>Board Size</td>
<td>0.006</td>
<td>.188</td>
<td>0.003</td>
<td>.973</td>
</tr>
<tr>
<td>Board Independence</td>
<td>-.583</td>
<td>.544</td>
<td>-.101</td>
<td>1.071</td>
</tr>
<tr>
<td>Capital Adequacy Ratio</td>
<td>-2.55</td>
<td>.480</td>
<td>.045</td>
<td>.532</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>-1.630</td>
<td>.746</td>
<td>-.208</td>
<td>-2.186</td>
</tr>
</tbody>
</table>

**Table 4.4: Regression Analysis**

- **Board Size:** From the regression, it is evident that Board size has negative relation with EPS but number of board of directors has no relation with banks’ ROA and ROE. Thus, it can be concluded that relationship between board size and bank performance is inconclusive. Effective performance of board of directors leads to a boost of bank’s
earnings. So, rather than number bank should focus more effectiveness and efficiency of directors performance.

**Board Independence:** The study also found that there is a negative relation exists between board independence and bank performance. Independent directors monitor board activities, ensure transparency in corporate decision making (Chen and Jaggi, 2000) This finding is consistent with Ramdani and Witteloostuijn (2009) who argued that board independence is inversely related to bank performance. Adverse effect of too many independent directors on bank performance may due to the fact that they consume more resources than they contribute to bank and thereby reducing bank performance.

**Internal Audit committee members:** Findings show that number of members in internal audit committee has a negative relation with bank performance. Rather than number, efficiency of auditor can contribute more in effective fraud detection. Apart from professional competencies, internal audit committee members must be independent of both the personnel and operational level.

**Capital adequacy ratio:** From the data it is evident that all the sample banks maintain minimum 10% CAR as required by Bangladesh Bank Guideline. Therefore, CAR doesn’t fall any significant impact on bank performance. Maintenance of adequate CAR reduces chances of banks becoming insolvent.

5. Conclusion and Managerial Implications:

The study aims at examining the impact of corporate governance on performance of commercial banks in Bangladesh and results reveal that number of independent directors in Board and members of internal audit committee are negatively related to bank performance. It is also evident that Board size (BDSZ) Capital adequacy ratio (CAR), as a measure of corporate governance mechanism does not affect bank performance.

As a means to strengthening performance of commercial banks along with central bank, shareholders should actively take part in establishing good governance. Keeping number of directors in a bank board to a optimum size is recommended. Because it enable the board to take quick decision and conduct activities properly and also helps to reduce Directors’ free riding problem. This research also suggest that number of independent directors in board and number of members in audit committee should be optimum. Rather than focusing on number, their efficiency and effectiveness should be the utmost consideration. And, bank should set their own benchmark regarding CAR, depending on the desired safety level.

6. Scope for Future Research:

The study can be improved by analyzing a longer time period. Financial data ranging over 20 years would be more reliable. Number of sample can also be expanded. The study use Board size, Board Independence, Members of Audit Committee and Capital Adequacy Ratio as tools to indicate corporate governance practices. Other corporate governance mechanism like ownership structure, Board meeting, Loan loss provision, loan to deposit ratio etc. can be taken into consideration. On the contrary, banks’ ROA, ROE and EPS are used to measure performance. There are still many variables such as Price Earnings Ratio; value added statement, economic value added statement etc. can be used to examine bank performance. Moreover, future research should also focus on assessing corporate governance mechanism from perspective of different stakeholders such as employees, management, depositors etc.

References


