BOARD GOVERNANCE REGULATION, PRACTICES AND THEIR RELATIONSHIPS WITH FINANCIAL PERFORMANCE: CAMBODIAN BANK AND MICROFINANCE INSTITUTION CONTEXT

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Abstract

To improve corporate governance practices of bank and microfinance institutions, the Cambodia National Bank has developed and imposed governance practices regulation for the sector. The current study investigates the current board governance practices of the sector and determines how the practices impact on financial performance. In addition, it tests the validity of relevant corporate governance theories to the context and the benefits of the regulation. The findings indicate that current board governance practices of the sector meet the minimum requirements of the regulation and, to a great extent, have positive impact on financial performance. The relevant theories validated and supported in the context of Cambodia banks and microfinance institutions.

Keywords: Board governance, Financial Performance and Bank and Microfinance Institution

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Introduction

The banking and microfinance sector in Cambodia has gained significant trust from the public in recent years (Nay, 2009). The level of credit to assets ratio has increased significantly with 14.27% in 2000 and 28.67% in 2008 (Nay, 2009). This success is a result of, among other factors, strong regulations and supervision imposed and carried out by the nation's banking regulatory authority, the National Bank of Cambodia (NBC). The NBC has implemented numerous Prakas (Regulations) to steer the sector to the right direction. Among the regulations imposed, the NBC has strong requirement for corporate governance practices. The regulation on governance practices 'Prakas on Governance in Banks and Financial Institutions' requires each bank and microfinance institution to have a board of directors as the governing body of the institution. The regulation further requires the board of directors to compose of qualified board members and active and independent board. In addition, the board shall establish audit, risks, remuneration and nomination committees (NBC, 2008). These requirements aim to improve efficiency and effectiveness of the governance and operations of the institutions and sector. Moreover, they are intended to improve corporate value as well. This regulation took effect in November 2008 and to date there isn't any empirical investigation on the current governance practices of the sector and or how the practices affect performance.

The objectives of the current paper are to conduct an empirical investigation on corporate governance practices of the sector, particularly board governance, and to find causal relationships between the practices and financial performance. Moreover, the study also tests relevant corporate governance theories and benefit of NBC's prescribed governance practices. The benefit of the prescribed governance practices is measured in term of financial performance. This paper has the following significance to the literature and regulatory authority. The contributions to corporate governance literature are as follow. First, it extends board governance studies to the context of a least developed economy country (LDC) likes Cambodia. Prior studies are predominately focused on developed economies (Dalton et al., 1999; Drobetz et al., 2003; Klein, 1998; Klein et al., 2005; McColgan, 2001; Rechner and Dalton, 1991; Wan and Ong, 2005). To the authors' knowledge, this study is the first that focused on corporate governance practices in private sector context in Cambodia; hence the paper introduces board governance practices of Cambodian bank and microfinance institution to the world. The study also adds to the few studies (Andres and Vallelado, 2008) on board governance practices in banking and financial institution sector, thus assists in uncovering board governance practices of the sector and their impact on financial performance. Second, the study determines the validity of agency, resource dependence and networking theories of corporate governance arrangements to the context. Turning to the significance of the study to the nation banking regulatory authority, the findings enable the NBC to know better of the current board governance practices employed by the sector, the current conformance level to the requirements of the regulation and the level of improvement needed. In addition, the NBC can determine appropriate enforcement level as well basing on the level of conformance. If the current practices meet the requirements already than little policing of the regulation is needed. On the other hand, strong enforcement is required; if the findings indicated that the sector has poor governance practices. In addition, the benefit of the prescribed practices would be proven if the finding indicates that the practices have positive impact on financial performance.

The findings of the study infer that the current board governance practices of the sector meet the basic requirements of the regulation. It indicates that majority of the institutions in the sample, 75%, has up to 88% of non-executive directors as members of their board of directors. In term of qualified director, which proxy by director's financial knowledge, the study found that 75% of the sample has 85% of directors with financial knowledge as members on their boards. Turning to causal relationships between board governance practices and financial performance, the findings infer that board independent has, on average, positive relationship with financial performance measured in term of return on assets (ROA). In addition, the number of qualified directors on the board has positive relationship with ROA. The study also finds that the number of foreign national board members has, on average, negative relationship with ROA. The number of directors on the board and the joint position of chief executive officer and chairman (CEO duality) have no significant impact on ROA.

The structure of the paper is as followed. The next section introduces the context of the study; its development, regulations and significance to Cambodia's economy. Section three provides literature review on board governance studies and briefly reiterating the contributions of the current study to the literature. Sections four and five provide the research methodology employed in the study and the findings. The last section provides conclusion remarks.

Cambodia Banking and Microfinance Sector

The banking and microfinance sector is one of the most developed sectors in Cambodia. This sector comprises of banks, commercial and specialized, and microfinance institutions that operate in similar ways as bank, however in a smaller scale (Nay, 2009 and Cambodia Economic Watch, 2005). This sector has undergone modernization in recent years, with almost all banks and microfinance institutions implemented electronic banking facilities. This includes the introduction of automatic teller machine (ATM) networks, online banking and electronic fund transfer at point of sales (EFPOST), mobile banking and backroom operations and clearinghouse functions (Tan, 2009). This is a great achievement for the sector since it was completely destroyed in the Khmer Rough regime and the long and continuous civil war.

The banking and microfinance sector in Cambodia has 22 commercial banks, 6 specialized banks and 18 microfinance institutions. The total assets of these institutions in 2008 are from $USD 1 million to $USD 500 millions. The deposit credit to total assets ratio on average is 28.67% (Nay, 2009). These figures show that the Cambodia's public as well as foreigners resided in Cambodia have confident in the country's banking systems. This confident level improves the sector development as well as the country's economy. Freeman (2007) contends that the sustained and rapid growth of Cambodian economy is due to, among other factors, strong investment growth in the banking and finance sector. The World Bank manager for Cambodia, Qimiao Fan, called the banking and finance sector as the savior of Cambodia economy during the time of world economic crisis (Tan, 2009). There are many foreign banks established their branches in Cambodia. This establishment further expands the sector.

The success in the development of the sector was achieved through strict regulations imposed by the National Bank of Cambodia (NBC). The NBC has issued numerous Prakas (Regulations) to enhance its abilities to monitor and supervise the sector. The Prakas includes Prakas on annual audit of financial statements of banks and financial institutions, Prakas on bank's solvency ratio and Prakas on governance in banks and financial institutions. The NBC has strict requirements on governance practices of the sector. There must be a board of directors for each institution and the members of board of directors should be qualified and active board members. In addition the board of directors as a whole should be independent from the management team (NBC, 2008). A qualified director, as prescribed by the regulation, should 'be trained if necessary so as to maintain a collective expertise, understand [his/her] role including the institution's risk profile' and passed NBC's fit and proper test (p 2, NBC, 2008). The NBC defines board independent as board that 'capable of exercising judgment independent of the views of management, political interests or inappropriate outside interests' (p 3, NBC, 2008). Article 6 of the Regulation requires at least two independent directors on the board of bank and at least one on the board of microfinance institution. The required minimum number of directors for a board is three. The board of directors should meet at least twice a year to be considered as active board. These board governance practice requirements are consistent with major professional bodies' recommendations, namely the Australian Stock Exchange (ASX Corporate Governance Council, 2003), the Business Roundtable (Business Roundtable, 2005) and the OCED principles of corporate governance (OECD, 2004). Furthermore, they are consistent with recommended practices in corporate governance literature (Klein, 1998; Klein et al., 2005; McColgan, 2001; Trole, 1997). The law on Banking and Financial Institutions, 1999, provides the NBC further powers to monitor the sector and promoting a sound financial system.

The banking and microfinance sector is also a key player in the upcoming opening of Cambodian Stock Exchange (Camex). Mr. In Channy, President and Chief Executive Officer (CEO) of Acleda Bank (the second biggest bank in Cambodia) has indicated that the bank 'want to list on the market so we can grow and grow. We need to raise capital. Investors need to be able to invest, and then to exit' (p 2, Postlewaite, 2009). The CEO of Union Commercial Bank also indicates his bank's intention to participate in the market in order to raise more capital. He believes that it would make his bank more aggressive in the competitive new world of Cambodia banking (Postlewaite, 2009). The biggest bank in Cambodia, Canadia bank, and Foreign Trade bank also express their interest to participate in the market (Hill, 2009).

The Cambodian banking and microfinance sector, thus, has important role in the country's socio-economic development. The sustain growth in the sector will lead to improvement in financial system, investments and growth in the private sector. It also assists in carry out the government's rectangular policies (Council for Development of Cambodia Website). Finally, it would definitely have indirect impacts on individuals' wellbeing; through job creation, improve technical skills and knowledge.

Literature Review

The structures of the board of directors, which include board leadership, board composition and board size, receive considerable attention in the literature. This is due to the belief that board of directors is the major controlling and monitoring mechanism in a modern corporation, where ownership is defused among many shareholders and no direct control on management. It is an agency theory driven approach.

The study of board leadership focuses on CEO duality, which tests the underlying assumptions of agency theory and stewardship theory. Agency theory contends that to be effective in monitoring management, the Chairperson should be independent from the management (Fama and Jensen, 1983). Donaldson and Davis (1991) argue that when the CEO is the Chairperson of the board of directors, the impartiality of the board is compromised. Consequently, the interests of the owners will be sacrificed to a degree in favour of management and incur agency loss. Alternatively, stewardship theory argues that the CEO should also hold the Chair position as because it provides a greater flexible work environment and a clear line of leadership (Donaldson and Davis, 1991). Nevertheless, majority principles of good governance practice require corporate leadership to be divided so that board of directors is independent from the management (ASX Corporate Governance Council, 2003; OECD, 2004; Business Roundtable, 2005). The empirical findings are somewhat mixed with evidence supporting CEO duality and other evidence supporting the separation between CEO and Chairperson positions. Donaldson and Davis (1991) study of US corporations' board leadership showed a positive relationship between CEO duality and performance. Firms with a CEO duality role showed higher return on equity (ROE) in relative to other firms. A study of board leadership in Australia's largest public listed companies shows similar results, where CEO duality has a positive relationship with both a market-based firm performance (measured by Tobin's Q) and an accounting-based firm performance (measured by ROA) (Kiel and Nicholson, 2003). The alternate findings come from Rebiez and Salamenh (2006), who study governance structure and financial performance in the construction industry. They find a positive linear relationship between the independence of CEO and Chairperson and market return. This finding is consistent with an earlier finding by Dahya et al., (1996) in UK listed companies context.

Another characteristic of board governance is board composition. In general, board composition studies focus on board independence and its relationship to organizational performance. The underlying assumption is that non-executive directors (NED) possess two desirable characteristics that enable them to fulfill their monitoring function. First, their independence and second their reputation. Fama and Jensen (1983), argue that reputation effects can provide NED with incentives to monitor managers. Moreover, Kaplan and Reishus (1990) and Gilson (1990) provide empirical evidences of a positive relationship between reputation capital and the directorship market. The empirical findings of whether NED impact on organizational performance show evidences support and reject the underlying assumptions. Kiel and Nicholson (2003) find the percentage of NED on the board correlates with performance on accounting-based measure (3 years ROA) but does not correlate to performance on a market-based measure (Tobin's Q). Bhagat and Black's (2002) study of board independence and long-term performance provides a clear cut finding that board independent does not improve performance. Their finding suggests that the more independent the board becomes the worse the firm perform. This negative result was supported by Yermack (1996), Agrawal and Knoeber (1996) and Bozec (2005) as they also find a negative relationship between proportion of NED and performance. A more recent study, in the context of international commercial banks (Cambodia excluded), also supports this finding (Andres and Vallelado, 2008). In their contribution to the debate on corporate governance reform in UK, Weir et al., (2002) found that NED is positively related to performance. Seng and Taylor (2008), in the context of government business enterprises (GBEs) find that NED has a strong and positive relationship with economic performance. Board independence is also found to increase shareholder wealth in a takeover situation (Cotter et al., 1997).

Other studies on directors' characteristics focus on their financial knowledge. Directors with a financial and accounting background (FLD), as well as being independent from the management, are deemed to have a more positive effect on an organization's achievement of its financial performance. Given the directors' function on the board and the audit committee of shaping financial planning and keeping a check on internal financial controls, their accounting and finance knowledge and experience are necessary for carrying out this function properly and efficiently (Agrawal and Chandha, 2005; Bull and Sharp, 1989; DeZoort, 1997). According, to resource dependence theory (Hillman and Dalziel, 2003), directors with finance and accounting knowledge are considered as board capital, providing resources to firm and contribute to firm performance. Chan and Li (2008) find that the presence of financial literate directors on an independent audit committee contributes to firm value. They indicate that the impact is five times as the impact of independent audit committee. They employ a broadly defined FLD variable, comprising directors from backgrounds of business school professor, CPA, top-level experience in a finance-related firm, chief financial officer, accounting firm partner and former Treasury official. In contrast, Defond et al., (2005) employ a much stricter definition of FLD which divides directors into accounting FLD and non-accounting FLD. Out of their 509 U.S. firms they found that the proportion of FLD has a positive relationship with cumulative abnormal return. A more recent study by Seng and Taylor (2008) indicated that FLD on the board is positively related economic rate of return.

Turning to the study of board size and performance, which dictated by two arguments. The first argument contends that increase in board size leads to increase in problems of communication and coordination and thus decreases the board's ability to control the management (Yermack, 1996). The other argument is that larger boards lead to less candid discussion of managerial performance and greater control by the CEO (Jensen, 1993). The empirical findings of board size effects on organizational performance indicate board size has a positive relationship with performance on a market-based measure but uncorrelated with accounting-based measure (Kiel and Nicholson, 2003). A study of board size in the US by Jensen (1993), Lipton and Lorsch (1992) and Yermack (1996) provide a clear cut finding in favour of companies with small board size. Yermack's data (1996) suggest that firms' value reduces when board size ranges between five and ten members. A recent study in the context Canadian SOEs also reveals that board size has a negative relationship with performance, measured by return on sales, sales efficiency and ROA (Bozec, 2005).

The literature on board governance is predominately focused on listed companies in developed economy countries, which are very much a different context to least developed economy country likes Cambodia. There are few studies on banking and finance sector, thus the study assists in uncovering governance practices of the sector and bring them to knowledge. The literature on causal relationships between governance practices and financial performance are inconclusive, hence no hypothesis on the relationship is developed for the study.

Research Methodology

Sampling and Data

The sample selected for the study is 43% of the population. This sample is selected basing on the number of publicly available annual reports gathered, year-ending December 2008. In other words, a search for annual report for the entire population was conducted and only 43% or 20 institutions have their annual reports publicly available. The list of bank and microfinance institutions is obtained from the NBC and Association of Microfinance Cambodia websites. The board governance data is collected in the corporate governance section of the institutions' annual report. The financial performance data is collected in the financial statements of the annual report. All institutions used Cambodian accounting standards as the base for preparing financial statements. According to the National Accounting of Cambodia (NAC), Cambodia uses the international financial reporting standards (IFRS) (NAC Website).

Variable Measurement

The study has three types of variable, namely control, independent and dependent variables. The control variables include size of the institution, which measured in term of average equity, and institution type, which measured using categorical data of 1,2,3 commercial bank, microfinance institution and specialized bank respectively. The independent variables under investigation in the study are non-executive director variable (NED), financial knowledge variable (FLD), percentage of foreign national director on the board (FNB), CEO duality and board size. These variables are measured as followed. The NED is measured by dividing the number of non-executive directors by the total number of directors on the board. The FLD variable is measured by dividing the number of directors with formal qualifications and experience in the fields of economics, finance or accounting by the total number of directors. The FNB is measured by dividing the number of FNB on the board by the number of total directors. CEO duality is measured using dummy variable of 1 for joint position of CEO and Chairman and 0 for separation of the two positions. Lastly, the board size variable is the total number of directors on the board.

Turning to the dependent variable, the financial performance variable is measured in term of return on assets (ROA) as followed:

ROA = Net income / Average of Assets

Financial performance measures like Tobin Q and other market value measures cannot be used as the sector is yet to be listed on a stock exchange. As mentioned above Cambodia Stock Exchange (Camex) is due to launch in the near furture.

Analysis methods

The number of institutions in the sample is 20, which limits the method available to use for analyzing the data. This small number of cases allows only correlation analysis to investigate the relationships between board governance practices and financial performance. In addition, the study also employs conventional descriptive statistics methods to report the current board governance practices of the sector. The data will be analyzed using SPSS software.

The Findings

Descriptive Statistics

The descriptive statistics of the current board governance practices of Cambodia' banking and microfinance sector are provided in Table 1. Panel A of the Table provides the statistics in term of number of directors whereas Panel

B provides the statistics on percentage basis. The maximum number of directors on the board in the sample is 10 directors and the minimum is 3 directors. This suggests that they have met the minimum number of directors required already. The number of FLD on the board ranges from 1 director to 8 directors, a 100% of the board (Panel B). More than 75% of the sample has boards with 85% of directors with finance knowledge and experience. Thus on this ground majority of the institution in the sector have met the qualified director requirement.

Table 1. Descriptive Statistics of Board governance practices (Panel A)

		Board Size	No. FLD	No. NED	Cambodian National Directors	Foreign National Directors	CEO Duality
N		20	20	20	20	20	20
Mean		6.15	4.20	4.50	2.95	3.35	.20
Median		6.00	4.00	4.50	3.00	3.00	.00
Mode		5(a)	3	5	3	0	0
Minimum		3	1	2	0	0	0
Maximum		10	8	9	8	9	1
Percentiles	25	5.00	2.25	3.00	1.00	1.00	.00
	50	6.00	4.00	4.50	3.00	3.00	.00
	75	7.00	6.00	5.75	4.75	5.00	.00

Descriptive Statistics of Board governance practices (Panel B)

		Parentage FLD	Percentage NED	Percentage FND
N		20	20	20
Mean		.6539	.7203	.5622
Median		.7750	.7321	.6905
Mode		.50(a)	.50	.00
Minimum		.11	.33	0
Maximum		1	1	1.00
Percentiles	25	.5000	.5139	.1875
	50	.7750	.7321	.6905
	75	.8512	.8810	.8893

Turning to the NED on the board, it ranges from 1 director to 9 directors (100% of the board, Panel B). Once again they have met the minimum number of NED required by the regulation. Therefore, these findings infer that the current board governance practices of the sector as of December 2008 are already met the minimum requirements of the National Bank of Cambodia's regulation on governance of the sector.

In term of CEO duality, Table 1 provides that more than 75% of the sample separate the Chairman position from the CEO position. This practice meets the conventional wisdom of agency theory. This aspect of board governance is not part of the requirements of the regulation (NBC, 2008).

Lastly, the data indicates that the number of foreign national director on the boards ranges from 0% to the maximum of 100% of the board of directors. A break down analysis in term of institution type (Table 2) indicates that the percentages of foreign national director aren't significantly different among the three types.

Table 2 Foreign National Directors and Institution Type

	N	Mean	Std. Deviation	Std. Error
Commercial bank	7	.7159	.32910	.12439
Microfinance institution	12	.5194	.37781	.10906
Specialized bank	1	.0	.	.
Total	20	.5622	.37859	.08466

Note: F Stat: 1.927, Sig.176

Correlation Analysis

Table 3 provides the result of the correlation relationship between the control variables and ROA. It indicates that organization size has no significant correlation with ROA. In contrast, the institution type is positively correlated with ROA. This suggests that microfinance institution and specialized bank are on average have higher financial performance, measured in term of ROA than commercial bank. A break down analysis using ANOVA is provided in Table 4. Similar result was found and significant at .10.

Table 3. Correlation Analysis: Control Variables and ROA

		Organization Size	Institution type	ROA
Organization Size	Pearson Correlation	1	-.490(*)	-.202
	Sig. (2-tailed)		.033	.406
	N	19	19	19
Institution type	Pearson Correlation	-.490(*)	1	.480(*)
	Sig. (2-tailed)	.033		.032
	N	19	20	20
ROA	Pearson Correlation	-.202	.480(*)	1
	Sig. (2-tailed)	.406	.032	
	N	19	20	20

Note: * Correlation is significant at the 0.05 level (2-tailed).

Table 4. ANOVA between ROA and Institution Type

	N	Mean	Std. Deviation	Std. Error
Commercial bank	7	.036384	.0154518	.0058402
Microfinance institution	12	.055049	.0187595	.0054154
Specialized bank	1	.061680	.	.
Total	20	.048848	.0192179	.0042973

Note: F Stat: 2.746, F Sig: 0.93

Turning to correlation analysis between board governance variables and financial performance, Table 5 indicates that only three out of the five board governance variables under investigation are significantly related to ROA. The NED is positively related to ROA; this result is consistent with findings from prior studies and in line with conventional wisdom of agency theory. In other words, non-executive directors are free of influence of the executive team and can make proper evaluation of investment proposals before them.

In addition to NED, the FLD is also positively correlated with ROA. This result suggests that a qualified director, proxy by financial knowledge, is a valuable capital for the board and the institution. Directors with financial knowledge can also make proper evaluation of proposals proposed by the executive team, their financial knowledge allows them to make thorough analysis on the financial outcome of the proposals and thus approve only profitable investments. Given the context of banking and microfinance, financial knowledge director is important. This is because most investment proposals are financially related. Thus this outcome is in line with resource dependence theory.

Another significant relationship indicated in Table 5 is the negative correlation between FND and ROA. This outcome suggests that Cambodian national director is preferred over foreign national directors. The outcome also suggests that Cambodian national director has better networking with local communities, government and authorities than foreign national directors. A review of the annual reports of the samples indicates most Cambodian directors are well connected in with the community and the government of all levels. To check whether this outcome is influence by qualified director aspect or not an ANOV is conducted on percentages Cambodia national directors with FLD and Foreign national director with FLD. The outcome is provided in Table 6. The F statistic and the significant of the ANOVA indicate that there isn't any significant different among the two. Thus, it can be reasonably judged that Cambodian national director is better networked and in turn contributes to the value of the institution.

Table 5. ANOVA of Percentage of Cambodia and Foreign National Directors with FLD

	N	Mean	Std. Deviation	Std. Error
Percentage of Cambodia national directors with FLD	20	.5861	.40347	.09022
Percentage of Foreign national directors with FLD	20	.4139	.40347	.09022
Total	40	.5000	.40770	.06446

Note: F Stat: 1.823, Sig: .185

The board governance variables of CEO Duality and Board size have no significant relationship with financial performance. These results are consistent with prior studies.

Thus the findings, to a great extent, have illuminated the benefit of the NBC's prescribed governance practices. The independent board of directors and the qualified director requirements have positive impact on financial performance. Only the board size requirement that does not show any significant relationship with financial performance.

Table 6. Correlation Analysis: Board Governance Variables and ROA

		Board Size	NED	FLD	Percentage of Foreign National on Boards (FND)	CEO Duality
Board Size	Pearson Correlation	1	.198	-.084	.360	.096
	Sig. (2-tailed)		.403	.725	.119	.687
	N	20	20	20	20	20
NED	Pearson Correlation	.198	1	.653(**)	-.024	-.400
	Sig. (2-tailed)	.403		.002	.919	.080
	N	20	20	20	20	20
FLD	Pearson Correlation	-.084	.653(**)	1	-.341	-.232
	Sig. (2-tailed)	.725	.002		.141	.326
	N	20	20	20	20	20
Percentage of Foreign National on Boards (FND)	Pearson Correlation	.360	-.024	-.341	1	.324
	Sig. (2-tailed)	.119	.919	.141		.163
	N	20	20	20	20	20
CEO Duality	Pearson Correlation	.096	-.400	-.232	.324	1
	Sig. (2-tailed)	.687	.080	.326	.163	
	N	20	20	20	20	20
ROA	Pearson Correlation	-.228	.444(*)	.732(**)	-.553(*)	-.266
	Sig. (2-tailed)	.334	.050	.000	.011	.258
	N	20	20	20	20	20

Note: * Sig at .05, ** Sig. at .001

Conclusion Remarks

In conclusion, the findings of the study infer that the sector has met the basic requirements of the National Bank of Cambodia's governance regulation. The majority of the institutions in the sample have met board size requirement, have at least one non-executive director on the board and have qualified directors. In addition, the sector employs separation of CEO and Chairman of the board position of governance practice and has foreign national directors on the board. These findings suggest that the National Bank of Cambodia does not need to allocate much resource to enforce the regulation, as the current practices meet the requirements already.

In term of literature, the study has extended board governance studies to least a developed economy context of Cambodia and further uncovering board governance practices of banking and finance institutions. The agency, resource dependence and networking theories of governance arrangements were also validated in the study. The findings are in line with theories.

The findings should be relied upon within limitation of language barrier. This is because one of the annual reports in the sample is in Khmer and translation into English was required before the data can be collected. Another limitation is the relatively small sample size.

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