

# OWNERSHIP STRUCTURE, CORPORATE GOVERNANCE AND BANK PERFORMANCE: EVIDENCE FROM GCC COUNTRIES

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## Abstract

The paper examines the effect of ownership structure and board characteristics on bank performance of GCC countries. Evidence indicates that the extent of the foreign ownership level has a significant positive association with the bank performance. However, concentrated ownership does appear to have a significant negative impact on performance and institutional ownership does not have any significant effect on performance. Other governance variables such as CEO duality and board size appear insignificant impact on performance. These results suggest a need to strengthen the internal control mechanisms within banks of GCC countries.

**Keywords:** Ownership, Performance, GCC, Corporate Governance

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## 1. Introduction

The issue of ownership structure and firm performance has been widely researched (Davies et al., 2005; Morck et al., 1988). Ownership structure is one of the main academic dimensions of corporate governance and moreover it is extensively seen to be determined by other country-level corporate governance characteristics (La Porta et al. 1998). Basically corporate governance concerns with the structure of rights and responsibilities among the parties with a stake in the firm (Aoki, 2001, Desender, 2009). However, the role of corporate governance reflected in the accounting and finance literature is the agency view (Fama and Jensen, 1983). In addition shareholders are concerned about maximizing returns, managers may prefer growth to profits and may maintain costly labour or product standards above the necessary competitive minimum (Desender, 2009). Therefore, in the presence of potential separation of ownership and control (Berle and Means, 1932), various mechanisms are assumed to align the interests of principals and agents (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976; Desender, 2009). Because of that the Desender (2009, p. 3) stated that "Agency costs arise because shareholders face problems in monitoring management: they have imperfect information to make qualified decisions; contractual limits to management discretion may be difficult to enforce". In order to reduce these costs,

various predetermined mechanisms, including corporate boards & ownership, are designed to align the interests of the management with those of the stockholders (Shleifer and Vishny, 1997; Klein, 1998). Moreover, it is understood from the literature the importance of banking and the financial sector to economic growth. Several studies found positive relationship between financial sector development and levels of income and growth (Levine, 1997; Khan & Senhadji, 2000).

During early 1980's the boom in oil markets has allowed the countries such as Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates to form the Arab Gulf Cooperation Council (GCC), to build up substantial financial wealth. The combined asset value of GCC banks is around U.S. \$250 billion (Limam 1998). The increase in income per capita and savings capacity in GCC countries have resulted in the development of a modern banking sector and this sector has been growing over time remarkably (Limam 1998). The GCC countries are witnessed by promoting privatization, banking regulation, market-oriented financial institutions, and entries of privately owned banks of different organizational structure (Omran, 2007). For example, within the GCC, countries that have been most successful in privatizing their banking institutions have also been involved in opening up their markets to foreign participants. For instance, Bahrain, Qatar took the lead in welcoming foreign banks. More interestingly

in many cases banks are owned by groups of families whose members are often directly involved in management (Limam, 1998). It is therefore an academic issue whether bank ownership structure and its impact on performance of the banking companies in the GCC as very few research study in this area. Although most of the available studies on the ownership-performance relationship have concentrated on developed countries, or focused on a single market, mainly the US (Lang and So, 2002). In addition, the corporate governance survey of GCC countries by the Institute of International Finance (IIF) and Hawkamah, the Institute of Corporate Governance has found that corporate governance practices across the GCC countries are lagging behind international standards.<sup>5</sup>

As this study is focused on finding out the relationship between ownership structure, board characteristics and performance of the firms, we will mainly concentrate on the shareholders/stakeholders who have a direct involvement in board's decision-making, namely the managerial shareholders who are a part of the Board of Directors. The purpose of this study is to undertake an empirical analysis of ownership structure and its relationship with the performance of the banking companies in the GCC contexts. We find that foreign ownership has a significant positive association with the bank performance. However, concentrated ownership has a significant negative impact on performance and instructional ownership does not have any significant effect on performance. Other governance variables such as CEO duality and board size appear insignificant impact on performance. This paper offers new insights into corporate governance practices in the GCC countries and underlines the need for reform in this area.

We contribute to the literature by examine the impact of ownership structure on bank performance in GCC countries. Our findings offer new evidence on ownership –performance relation, in particular with reference to the GCC bank. The findings of this study may be useful to make a comparison with banks of other countries. Moreover, the outcome of the paper helps to adopt an appropriate balance of legislation and regulatory reform to make improvements in the corporate governance practice of the GCC banks.

The rest of the paper is structured as follows. Section 2 reviews related literature and develops hypotheses. Section 3 describes research methodology. Section 4 presents empirical results and finally section 5 concludes the paper.

## 2. Literature Review and Hypotheses Development

There have been substantial literature on whether and how the ownership structure affects corporate performance. It is assumed from the theoretical side that when the ownership in a firm is diffused, shareholders are not motivated to monitor management decisions closely as the benefit is too small in this case. Within this framework, we would like to measure firm performance based on ownership concentration and ownership identity and below is the discussion on these issues.

### 2.1 Concentrated Ownership and firm performance

Since Berle and Means (1932) the effect of ownership concentration on company profitability has been studied (Ongore, 2011). Traditionally, concentrated ownership has been thought to provide better monitoring incentives, that lead to superior performance (Leech and Leahy, 1991). On the contrary, it might also lead to extraction of benefits by the controlling shareholders by the minority shareholders (Maher and Andersson, 1999). It is noted that the principal-agent model suggests that managers are less likely to engage in strictly profit maximizing behaviour in the absence of close monitoring by shareholders (Prowse, 1992; Agrawal and Knoeber, 1996). The study of Gugler (1999) provides a comprehensive survey of the effects of ownership concentration on corporate performance, beginning with the pioneering work of Berle and Means (1932) to more recent work by Leech and Leahy (1991), Prowse (1992), Agrawal and Knoeber (1996), and Cho (1998). Based on primary studies from the US and UK, he finds that although, the results are ambiguous, the majority of studies find that firms with concentrated ownership tend to significantly outperform manager-controlled firms (Ongore, 2011). On the other hand, concentrated ownership provides managerial entrenchment and self-aggrandizing behaviour, which might reduce the value of the firm—that is, the firm incurs high agency cost for lack of transparency (Morck et al. 1988; Shleifer and Vishny 1997). Therefore, the impact of concentrated ownership on bank performance firms is an empirical issue and therefore, we propose following hypothesis:

*Hypothesis H1: Ownership concentration has a significant effect on the bank performance*

### 2.2 Ownership Identity and firm performance

The relevant literature on corporate governance pays much attention to the issue of shareholder identity (Shleifer and Vishny, 1997; Welch, 2004; Xu and Wang, 1997). The above studies argue that the

<sup>5</sup> For more detail information see <http://www.ameinfo.com/96664.htm>

objective functions and the costs of exercising control over managers vary substantially for different types of owners. It is important, not only how much equity a shareholder owns, but also who this shareholder is, (i.e. private person, manager, financial institution, non-financial institution enterprise, multi-national corporation or government (Ongore, 2011). To the extent that owners have their economic relations with the firm, conflicts of interest may arise. For example, banks may play a dual role as lenders and owners, government as regulators and owners (Thomsen and Pedersen, 1997). For each of these stakeholders, preferences regarding company strategy will involve a trade-off between the pursuit of shareholder value and other goals. Thomsen and Pedersen (2000) suggest that the relationship between ownership concentration (as a proxy for shareholder control over managers) and firm performance depends on the identity of the large (controlling) shareholders. This is because of that different types of shareholders have different investment priorities, and have preferences of how to deal with managers' agency problems (Ongore, 2011).

### **2.2.1 Foreign Ownership:**

The effect of foreign ownership on the firm's performance has been an issue of interest in the previous researches. The result of these studies is mixed. For instance, Drakos (2002), Jerimic and Vujcic (2002) conclude that foreign entry may improve the overall performance of the banking system. Additionally, Hassen and Marton (2003) find that the bank efficiency is positively related to foreign compared to the state ownership. Further, Fries and Taci (2005) find that privatized banks with majority foreign (domestic) ownership are most (least) efficient. Further, Bonin et al. (2005a) find that foreign-owned banks are significantly more cost efficient than domestic banks. The main reasons have been put forward to explain the relationship of high performance associated with foreign ownership are firstly, the foreign owners are more likely to have the ability to monitor managers, and provide them performance based incentives therefore the manager will be more serious, provide the investors the right information and avoid the entrenchment or any passive behaviour that destabilizes the value creation of the firm. Secondly, the technology provided by the foreign investors helps the managers to enhance on the efficiency by reducing the operating expenses and generating saving for the firm. In contrast, Nikiel and Opiela (2002) observe that foreign banks are less profit efficient than domestic banks. Also, Lensink et al. (2008) find that an increase in foreign ownership is negatively linked to the banking efficiency. Therefore we propose the following hypothesis:

***Hypothesis H2:** The foreign ownership has a positive effect on the firm performance*

### **2.2.2 Institutional Ownership:**

Several studies have focused their attention on the impact of institutional ownership on the firm performance. The empirical results find mixed findings (McConnell and Servaes, 1990; Lakonishok et al., 1992). The study of DelGuercio and Hawkins (2001) revealed that institutional ownership has a significant positive impact on performance. Institutional investors are often regarded as active monitors that strive to maximize the value of their equity investments in firms (Chen, Harford, and Li, 2007). In addition, there is a positive relation between firm value and ownership by institutional investors. The main reason has been put forward to explain the phenomenon of high performance associated with institutional ownership is that the institutional ownership would reduce the principal-agent problem between managers and shareholders, which would in turn lower the incentives and opportunities for managers to control earnings while raising the effectiveness of the performance.

In contrast, according to the other researches such as studies of Black (1990), Bushee (1998), Dong and Ozkan (2007), support the absence of institutional investor's incentives to influence or to be implicated on government or management of firms in their portfolios. They choose to adopt a passive behaviour, and are mainly interested by short-term returns of their stocks. This strategy is called "myopic investors" (Porter, 1992; Bushee, 1998; Dong and Ozkan, 2007). The main reason has been put forward to explain the negative impact of such investors on the firm performance is that these investors prefer to take the most advantages from stock prices variations, even if these fluctuations are temporary, and influence, consequently, in a negative way long-term performance of these firms. Therefore the effect of the institutional owners on the bank performance is an empirical question.

***Hypothesis H3:** The institutional ownership has a positive effect on the firm performance.*

## **2.3 Corporate governance**

Corporate governance is represented by board size and CEO duality.

### **2.3.1 Board Size:**

Prior research has found significant links between board size and the firm performance. Earlier studies such as Lipton and Lorch (1992), Jensen (1993) recommend a limited number of directors on a board to seven or eight, as numbers beyond that it would be difficult for the CEO to control. This can be explained that when boards consist of too many members agency problems may increase, as some directors may tag along as free-riders. Hermalin and Weisbach

(2003) argue that larger boards can be less effective than small board. In contrast, more recent studies have revealed a positive relationship between board size and performance (measured by Tobin's Q) in the U.S banking industry (Adam and Mehran, 2005; Dalton and Dalton, 2005). It is argued that larger board may enhance performance because they have valuable business experience, expertise, skill and social and professional network which might add substantial resources (Setia-Atmaja et al., 2009). Therefore, it is true that the size of the board has an important factor in dealing with corporate decisions and performance. Within this frame work, we can hypothesized that

### 2.3.2 Duality:

Early studies beginning with Fama and Jensen (1983) argue that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management. Kang and Zardkoohi (2005) argue that CEO duality reduces the firm performance due to CEO entrenchment and a decline in board independence. In addition, CEO duality provides the CEO the power to negotiate with the board which may help the CEO to pursue self-serving interest. Also, Yermack (1996) tended to find that firms are more valuable when the CEO and board chair positions are separate. Sanda et al (2003) find a positive relationship between firm performance and separating the functions of the CEO and Chairman. Therefore, they advocate separation of the leadership

$$P = B_0 + B_1 BS_j + B_2 DUA_j + B_3 BLOCK_j + B_4 INSTITUTIONAL_j + B_5 FOREIGN_j + \text{LogASSETS}_j + \varepsilon_{ij}$$

The dependent variable is ROA. ROA is measured as earnings before interest and taxes (EBIT) to book value of total assets (Anderson and Reeb, 2004). ROA is an indicator informing the user about how profitable a company is relative to its total assets. ROA is directly related to management's ability to efficiently utilize corporate assets, which ultimately belong to shareholders. We define board size is defined as the number of directors on the board (denoted as *BS*) (Setia-Atmaja et al., 2009). *CEO duality (DUA)* refers to the situation where the same person serves the role of the CEO of the firm as well as the Chairman of the board. Consistent with the prior study this study uses the CEO duality variable as a dummy, which is equal to 1 if the CEO and Chairman are the same person and 0 otherwise (Boyd, 1995). *Block holders (BLOCK)* is the aggregate fractional holdings of entities holdings more than five per cent of the firm's shares (Anderson and Reeb, 2003).

*Institutional ownership (INSTITUTIONAL)* is defined as institutional shareholdings as a percentage of total outstanding shares and *foreign ownership (FOREIGN)* is measured as foreign shareholdings as

roles to rise the independence of the board, to eliminate a source of conflict and to increase the performance. Therefore, it would seem that the duality has a negative effect on the bank performance.

**Hypothesis H5: The duality has a negative effect on the firm performance**

## 3. Methodology

### 3.1 Sample

The sample for this study consists of all banks of the GCC countries excluding Kuwait because of data restriction. The data have been used for 2008 and collected from respective stock exchanges. We limit our sample to listed banking firms because firm-level data on the ownership structure of all firms cannot be collected from the present position. Data on both corporate performance and ownership structure is collected from annual reports or publications by the respective stock exchanges. Our final sample comprise of 27 banks from GCC countries.

### 3.2 Model specification

The following is the general form of the OLS regression model which has been fitted to the data in order to assess the effect of each variable on the firm performance and to test the associated hypotheses:

a percentage of total outstanding shares (Farooque et al., 2007). We control bank size which may affect firm performance. *Bank size (LogASSETS1)* is measured as a natural logarithm of total assets (Yarmack, 1996), since the countries have similar bank size and almost the same regulatory conditions.

## 4. Findings and Analyses

### 4.1 Descriptive Statistics

Table 1 show that the number of director's average around 9 and average 44.44 per cent banks has CEO duality. With regard to ownership structure such as block holders, foreign and institution hold an average of 85.19 per cent, 10.12 per cent and 28.03 per cent of shares respectively in all sample banks. Therefore it is observed that the banks in the sample are characterized by a high concentrated ownership and it is dominated by a strong presence of institutional investors with the participation of the foreign investors. The average firm performance (ROA) is 19.80 per cent. The average firm size is 17.1030 (natural logarithm of total assets).

**Table 1.** Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max	N
ROA	.0198	.01371	-.03	.05	27
BOARD SIZE	9.1852	1.52005	7.00	12.00	27
DUA	.4444	.50637	.00	1.00	27
FOREIGN	.1012	.18033	.00	.71	27
INSTITUTIONAL	.2803	.21788	.00	.70	27
BLOCK	.8519	.36201	.00	1.00	27
LOG ASSETS	17.1030	1.74695	12.19	19.00	27

**Table 2.** Correlation Matrix

	ROA	BOARD SIZE	DUA	FOREIGN	INSTITUTIONAL	BLOCK	LOG ASSETS
ROA	1						
BOARD SIZE	-.011	1					
DUA	-.024	.189	1				
FOREIGN	-.156	.101	-.235	1			
INSTITUTIONAL	-.076	.072	-.278	.386*	1		
BLOCK	-.471*	.331	.373	.239	.118	1	
LOG ASSETS	.491**	-.095	.174	-.487**	.081	-.042	1

\*. Correlation is significant at the 0.05 level (2-tailed).  
\*\*. Correlation is significant at the 0.01 level (2-tailed).

#### 4.2. Correlation matrix and multicollinearity analysis:

Multicollinearity in explanatory variables has been diagnosed through analyses of correlation factors and Variable Inflation Factors (VIF), consistent with Weisberg (1985). Table 2 presents the correlation matrix of the dependent and continuous variables, from which, it has been observed that the highest simple correlation between independent variables was 0.49 between log assets and performance. Bryman and Cramer (1997) suggest that simple correlation between independent variable should not exceed 0.8 or 0.9. The VIF in excess of 10 should be considered an indication of harmful multicollinearity (Neter et al., 1989). Alternatively, if the average VIF is substantially greater than the regression be biased (Bowerman & O'Connell, 1990). The average VIF (0.819) is close to 1 and this confirms that collinearity is not a problem for this model<sup>6</sup>. These findings suggest that multicollinearity between the independent variables is unlikely to pose a serious problem in the interpretation of the results of the multivariate analysis.

<sup>6</sup> The average VIF is computed by summing all VIF values in the last column located in Table 3 and then divided by the number of explanatory variables.

#### 4.3. Discussion of regression results:

Table 3 presents the OLS estimations of the relationship between ownership structure and bank performance (measured by ROA) of GCC and results demonstrate that the F-ratio is 4.498 ( $P = 0.005$ ). The result statistically supports the significance of the model. An adjusted  $R^2$  of 0.447, which implies that independent variables explain 44.7% of the variance of the performance and this result consistent with previous studies using firm performance (Demsetz 2001; Thomsen and Pedersen, 2000).

The result suggest that the impact of foreign ownership on performance is positive and significant (i.e.,  $\beta = 0.030$ ,  $t = 2.015$ ,  $p < 0.05$ ). This finding lends support to Hypothesis 4. This implies that foreign ownership in firms facilitated stronger outside monitoring of managers and helps to reduce agency costs (Randoy and Goel, 2003). Claessens et al (2000) also report that in developing countries, foreign banks perform significantly higher than the domestic banks. Furthermore, Bonin and Moreover, Bonin et al. (2005b) who find that financial performance is significant improved after divestiture, and that "the new owners, mainly foreign, incur the costs to upgrade the technology and develop new business lines". This result supports the idea that in GGC

market, which is characterized by an open equity market to the foreign investors as well as an encouragement of the long term investment by offering a diversity of Islamic products particularly “Sukuk”.

With regard to block ownership, the OLS regression indicates that it has a negative and significant impact on performance (i.e.,  $\beta = -0.023$ ,  $t = -3.506$ ,  $p < 0.01$ ). This result suggests that block ownership provides managerial entrenchment and self-aggrandizing behaviour. As a result, it reduces minority owner’s ability to monitor and control behaviour of the firm’s leadership, which might reduce the value of the firm—that is, the firm incurs high agency cost for lack of transparency (Morck et al. 1988; Shleifer and Vishny 1997). However, institutional ownership does not appear to improve

performance, in banks of GCC due to lack of proper incentives to positively influence the bank’s management. Furthermore, board size and CEO duality appears to have an insignificant impact on bank performance.

For the control variable, the bank size has a positive impact on the bank performance (i.e.,  $\beta = 0.005$ ,  $t = 3.783$ ,  $p < 0.01$ ). This is consistent with previous studies (Adams and Mehran 2003, Levine, 2004). This result reflects the characteristics of GCC banks which is based on the diversification of the assets in order to improve the profitability as Deputy CEO of HSBC Global Banking in the Middle East explains “The divergence in performance between the Middle East and other emerging markets makes the region very attractive as a source of diversification,”

**Table 3.** Regression results

$P = B_0 + B_1 BS_j + B_2 DUA_j + B_3 BLOCK_j + B_4 INSTITUTIONAL_j + B_5 FOREIGN_j + LogASSETS_j + \epsilon_j$				
Variable	$\beta$	t-value	Sig.	VIF
Constant	-.070	-2.529	.020	
BOARD SIZE	.002	1.382	.182	1.646
DUO	.002	.469	.644	1.204
FOREIGN	.030	2.015	.058	0.891
INSTITUTIONAL	-.013	-1.173	.255	0.625
BLOCK	-.023	-3.506	.002	0.404
LOG ASSETS	.005	3.783	.001	0.149
<b>Model summary</b>				
R <sup>2</sup>				0.574
Adjusted R <sup>2</sup>				0.447
F-value				4.498
Sig.				0.005

## 5. Conclusion

The globalization creates a new level of interest in understanding the governance practices in GCC banks. So far there have been few of studies emphasizing on corporate governance practices in developing countries particularly GCC. The main objective in this study is to identify the impact of the ownership structure and board characteristics on the bank performance. Evidence indicates that there is a positive and significant association between the foreign ownership and bank performance measured by ROA. This implies that foreign ownership facilitated stronger outside monitoring of managers. However, concentrated ownership is negatively associated with performance. This suggests that concentrated ownership provides greater opportunities for managerial entrenchment and expropriation of minority shareholders. However, the board characteristics such as board size and CEO duality

have an insignificant impact on performance. The existing corporate board in GCC bank is still at the infancy stage. Because of the emergent nature of boards it has no impact on performance. Moreover, the results also show that the size of the bank affects positively on performance, which is consistent with the notion that larger bank tend to have ability for efficiency improvement through resource consolidation and alliance with other banks (Limam 1998). Overall, this study offers new insights into corporate governance practices in GCC banks and underlines the need for reform in this area.

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