CORPORATE GOVERNANCE AND BANK PERFORMANCE: EVIDENCE FROM BANGLADESH

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Abstract

The study investigates the relationship between the corporate governance structure and performance of listed banks in Bangladesh. We find that board independence and board size have a significant positive impact on performance. However, female directors appear to have no impact on performance. Our evidence indicates that the extent of the managerial ownership level has a significant negative impact on bank performance. These results suggest that better corporate governance mechanisms are imperative for every banking company and should be encouraged for the interest of the investors and other stakeholders.

Keywords: Corporate governance, Performance, Bank, Bangladesh

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1 Introduction

This study investigates the relationship between corporate governance and performance of listed banks in Bangladesh during the period 2005-2010. Due to the separation of ownership and control in large corporations, there is a problem of aligning the interest of dispersed shareholders with that of management, leading to the agency problem (Jensen and Meckling, 1976). To mitigate agency problems various internal and external corporate governance mechanisms have been suggested. The governance mechanisms include board structure, debt financing, equity ownership by insiders and outsiders, and market for corporate control (Haniffa and Hudaib, 2006).

Though there are many studies on corporate governance, yet only a few empirical studies focus on banks' corporate governance (e.g., Adams and Mehran, 2003, 2005; Caprio et al, 2007; Levine, 2004; Andres and Vallelado, 2008; Elyasiani and Jia, 2008; Macey and O'Hara, 2003). These studies analysed the effectiveness of the boards of directors in monitoring and advising managers in the banking industry. It is expected that banks with boards that are more effective in terms of monitoring are better governed, and that better governance creates shareholder value. The governance of banks may be different from that of unregulated, non-financial firms for several reasons. One is that the number of parties with a stake in an institution complicates the governance of financial institutions. In addition to investors, depositors and regulators also have a direct interest in banks' performance. All together, regulators are concerned with the effect of governance on the performance of financial institutions because the growth of the economy depends on their performance. As a result, the board of directors and ownership structure of a bank can play a crucial role in its governance structure.

More recent times there have been some efforts to improve corporate governance practices in Bangladesh. As a part of World Bank reform programme, the Securities and Exchange Commission (SEC) in Bangladesh issued a 'Corporate Governance Notification' in 2006, which consists of guidelines with regard to corporate governance practices including board structure of the listed companies on 'Comply or Explain basis'. This notification requires that board size of a company should be limited between 5 to 20 members, one tenth of the board members should be independent members, the office of the Chairperson of the Board and the Chief Executive Officer (CEO) should preferably be filled by two different individuals. It is argued that effective corporate governance leads to high level financial performance as well as market valuation (Klapper and Love, 2004; Rajagopalan and Zhang, 2008). An examination of different aspects of board structure which is an important governance mechanism provides us an insight to the improvements in corporate governance in banking sector in Bangladesh.

We find, based on recent data from Bangladeshi public-listed banks, that board independence has a positive and significant impact on firm performance. This implies that board monitoring by independent directors improves firm performance which is supported by agency argument. Consistent with the resource dependence theory our result also suggest that larger boards provide valuable business experience, expertise, skill and social and professional network which might add substantial business resources to the firms and thus positively impact on bank performance. Furthermore, we document that female directors do not have any significant impact on performance. However, managerial shareholdings have a significant negative impact on performance.

The findings of this study contribute to the literature in a number of ways. We examine the impact of corporate governance on bank performance in an emerging market setting such as Bangladesh, where there is a limited research on corporate governance practices. Corporate board as a critical governance mechanism is important for Bangladeshi publicly listed companies due to recent recommendations by the SEC that outlines some requirements for board structure. Overall, the outcome of the study helps to adopt an appropriate balance of legislation and regulatory reform to make improvements in the corporate governance practice of the banking sector of Bangladesh. The findings of this study may be useful to make a comparison with banks of other countries.

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

Board Independence and Bank Performance

Agency theory suggests that a higher proportion of independent directors[1]should lead to better firm performance since it reduces the conflict of interests between the shareholders and managers and makes management more effective through better monitoring (Fama and Jensen, 1983; Shleifer and Vishny, 1997). Previous study finds that board independence is positively related to bank performance (Anders and Vallelado, 2008).

However, Agrawal and Knoeber (1996) document a negative relationship between board independence and firm performance. They argue that independent directors are sometimes added to boards for political reasons and these directors have lack of monitoring expertise which in turn affects firm performance negatively. There are also a group of studies which find that board independence does not have any effect on firm performance (Hermalin and Weisbach, 1991; Choi and Hasan, 2005).

Family dominance and poor regulatory oversight in Bangladesh implies the need of independent directors to protect the interest of minority shareholders. The agency theory suggests that higher portion of independent directors will increase the monitoring and reduce any self-interested actions by managers and therefore, will be related to better firm performance. The first hypothesis is based on agency theory and is proposed accordingly.

H1:The proportion of independent directors on board is positively related to bank performance.

Board Size and Bank Performance

Prior research has found significant links between board size and firm performance. Lipton and Lorsch (1992) argue that a larger board may face poor coordination due to the large number of potential interactions among group members and free riding problem. The empirical evidence supports this contention by showing an inverse relation between board size and firms performance (see for example, Yermack, 1996; Eisenberg et al., 1998).

On the other hand, previous studies have revealed a positive relationship between board size and performance (measured by Tobin's Q) in the US banking industry (Adam and Mehran, 2005; Dalton and Dalton, 2005). It is argued that larger boards may enhance performance because they have valuable business experience, expertise, skill and social and professional networks which might add substantial resources (Setia-Atmaja et al, 2009). Therefore, it is true that the size of the board is an important factor in dealing with corporate decisions and performance. Within this framework, we can hypothesize that

H2: Board size has a significant impact on bank performance

Female Directors and Bank Performance

It is argued that diversity of corporate board enhances better monitoring and it increases board independence (Mace, 1971). There have been several empirical studies that document a significantly positive relationship between gender diversity and firm performance (Carter et al., 2003; Francoeur et al., 2008; Smith et al., 2006).

Previous studies, on the other hand, document a negative relationship between the proportion of female directors and performance (Shrader et al., 1997; Bohren and Stron, 2010; Adams and Ferreira, 2009). The findings of these studies suggest that female board members may be appointed on the board as a sign of tokenism, and as such their contributions may be marginalized.

In Bangladesh, female board members are usually appointed based on family ties. In most cases, the founder owners or directors appoint their wives and daughters on the boards, often with the motive of increasing family voting power or dominance (Uddin and Choudhury, 2008). As family members, they do not need to bring in-depth business perspective, skill or educational qualifications (Uddin and Choudhury, 2008). Although gender inequality still prevails in Bangladesh, it is expected that female board members will prove their competencies by efficient monitoring and accordingly can improve firm performance.

Based on the above discussion we propose the following hypothesis.

H3: There is a significant positive impact of proportion of female directors on bank performance.

Managerial Ownership and Bank Performance

The pattern of ownership structure of a corporation is likely to affect the nature of agency problems between managers and shareholders which in turn may affect the performance of a firm. Jensen and Meckling (1976) argue that the managerial ownership can mitigate agency problem since it aligns the interests of managers and shareholders. It can also yield a positive impact on firm performance. It is also argued that an increase in share ownership beyond the minimum level may entrench the managers and exacerbate the agency conflict because increases in managerial ownership give them extra voting power to ensure that their position in the corporation is secured (Demsetz, 1983). Therefore, it reveals that various levels of managerial ownership may affect firm performance differently (Morck et al., 1988; Short and Keasey, 1999**;** Kole, 1995; Davies et al., 2005).

However, the impact of managerial ownership on bank performance firms is an empirical issue and therefore, we propose the following hypothesis:

H4: There is a significant relationship between director's shareholdings and bank performance.

3 Data and Sample Selection

The sample consists of all 30 banks listed with Dhaka Stock Exchange (DSE) in Bangladesh from 2005 to 2010, producing a total sample of 180 over the period under study. Due to missing information, we excluded 11 firm year observations, yielding a final sample of 169 firm-years observations. The data for our analysis comes from multiple sources of secondary data. We collected the financial data from the annual reports of the sample banks listed on the stock exchange. Stock price data is obtained from the DataStream database. Corporate governance data was hand collected from the corporate governance disclosures and directors' report contained in annual reports.

Model Specification

The following model is used to test Hypotheses *H1*, *H2*, *H3 and H4*

$$PERFORMANCE\ (ROA) = \alpha + \beta_1 BIND + \beta_2 BSIZE + \beta_3 FEMDIR + \beta_4 MOWN + \beta_5 ROA_{t-1} + \sum_{i=1}^{n} \beta_i\ OTHERS + \varepsilon$$

Where,

ROA	Earnings before interest and taxes (EBIT) to book value of total assets
BIND	Proportion of independent directors on the board
BSIZE	Number of directors on the board.
FEMDIR	Proportion of female directors on the board
MOWN	Shareholdings held by directors
ROA_{t-1}	ROA lagged one year[2]
Others Control variables:	
FSIZE	The natural log of book value of assets
FAGE	The natural log of number of years since firm inception
RISK	Standard deviation of the firm's daily stock return over the prior 12-month period
GROWTH	Firm's assets growth ratio
LEVERAGE	Ratio of book value of total debt to book value of total assets.

4 Results

Descriptive Statistics

Table1 presents descriptive statistics for the full sample. It provides means, medians and standard deviations for the main variables of the full sample. The average number of director is around 13, 3.34 per cent are independent directors (*BIND*) and 12.64 per cent are female directors (*FEMDIR*). Moreover, average directors share ownership is 20.61 per cent. The average ROA of our sample firms is 0.0165. The average firm age (*FAGE*) is nearly 18 years and the average firm size (*FSIZE*) is 24.64 (natural logarithm of total assets).

Table 1. Descriptive Statistics for the Full Sample

Variable	Mean	Median	Std. Dev.	Observations
ROA	0.0165	0.0168	0.0156	169
BIND	0.0334	0.0000	0.0465	169
BSIZE	12.9118	13.000	4.2018	169
FEMDIR	0.1264	0.0909	0.1401	169
MOWN	0.2061	0.2000	0.1133	169
ROA_{t-1}	0.0142	0.01600	0.0182	169
FSIZE	24.6440	24.6226	0.6065	169
FAGE	17.959	13.500	10.979	169
RISK	0.0272	0.0253	0.0193	169
GROWTH	1.3494	0.2608	11.4731	169
LEVERAGE	0.9304	0.9300	0.0940	169

ROA=Earnings before interest and taxes (EBIT) to book value of total assets, BIND=Proportion of independent directors on the board, BSIZE= Number of directors on the board, FEMDIR=Proportion of female directors on the board, MOWN =Shareholdings held by directors, ROA_{t-1} = ROA lagged one year, FSIZE=The natural log of book value of assets, FAGE = The natural log of number of years since firm inception, RISK=Standard deviation of the firm's daily stock return over the prior 12-month period, GROWTH = Firm's assets growth ratio, LEVERAGE= Ratio of book value of total debt to book value of total assets

Multivariate Regression Analysis

The main focus of our analysis is to examine the impact of corporate governance on performance measured by ROA in banks in Bangladesh. The results are reported in Table 2.

Board independence (BIND) is found to have a significant and positive ($\beta = 0.060465$, $p < 0.01$) relationship with performance, thus allowing us to accept hypothesis 1. This is consistent with the findings of Anders and Vallelado (2008). They argue that independent director to the board improves monitoring and reduces the conflict of interest among stakeholders. The coefficient of board size is positive and significant ($\beta =0.010253$, $p < 0.01$). Overall our results support H2. Consistent with the resource dependency argument our results suggest that board size has a positive impact on the bank performance. The findings of our analysis support previous studies such as Dalton et al. (1998) and Jackling and Johl (2009) which reveals that larger boards provide valuable business knowledge, expertise, skill and social and professional network to the firms. Therefore, decision making process as well as firm performance is improved. However, the coefficients of female directors (FEMDIR) are insignificant. It implies that female directors do not affect firm performance of our sample companies. Thus H3 is not supported. One possible explanation for this finding is that in Bangladesh, female directors could be appointed just as a sign of tokenism (Shrader et al., 1997) and that they may not have sufficient knowledge nor skills to oversee the activities and improve firm performance.

In terms of managerial ownership (MOWN), the results indicate a significant negative ($\beta =-0.030549$, $p < 0.01$) relationship with ROA. The negative result supports the findings of Haniffa and Hudaib (2006), who suggest that increase in share ownership of directors may entrench themselves and may pursue more risky strategies to maximise their own interest, consequently leading to lower performance.

With respect to the control variables, we find that firm size (FSIZE) and growth (GROWTH) has a positive and significant relationship with bank performance. However, leverage (LEVERAGE) and firm age (FAGE) are negatively related to bank performance.

Table 2. Multivariate Regression Analysis (Dependent variable= ROA)

Variable	Coefficient	t-Statistic	Prob.
Constant	-0.090	-1.934	0.055
MOWN	-0.031	-2.924	0.004
BSIZE	0.010	3.390	0.001
BIND	0.060	2.750	0.007
FEMDIR	-0.009	-1.235	0.219
FSIZE	0.005	2.589	0.011
LEVERAGE	-0.028	-2.599	0.010
GROWTH	0.000	2.272	0.025
FAGE	-0.007	-2.770	0.006
RISK	-0.005	-0.107	0.915
ROA_{t-1}	0.369	6.615	0.000
Adjusted R-squared	0.462		
F-statistic	15.402		
Prob(F-statistic)	0.000		

ROA=Earnings before interest and taxes (EBIT) to book value of total assets, BIND=Proportion of independent directors on the board, BSIZE= Number of directors on the board, FEMDIR=Proportion of female directors on the board, MOWN =Shareholdings held by directors, ROA_{t-1} = ROA lagged one year, FSIZE=The natural log of book value of assets, FAGE = The natural log of number of years since firm inception, RISK=Standard deviation of the firm's daily stock return over the prior 12-month period, GROWTH = Firm's assets growth ratio, LEVERAGE= Ratio of book value of total debt to book value of total assets.

5 Conclusions

Corporate board and ownership can play a significant role in ensuring better corporate governance practices. Accordingly, we investigate the relationship between board structure and board ownership on performance using a sample of 30 listed banks in Bangladesh. We find that board independence has a positive impact on banks' performance in Bangladesh. This is consistent with the monitoring perspective of agency argument. We also document that board size is positively related to firm performance. However, we did not find any significant relationship between female directors and bank performance as female directors are usually appointed on the basis of family ties in Bangladesh, they usually do not need any qualifications or expertise. Further, managerial ownership seems to be detrimental to performance since it provides managerial entrancement and provide opportunities to misallocation of firm's resources at the expenses of other shareholders. Overall, this study offers new insights into corporate governance practices in the banking sector of Bangladesh and underlines the need for reform in this area.

Notes

1. An independent director in Bangladesh means a director who does not hold any share in the company or who holds less than 1 percent of total paid up shares of the company; who is not connected with the company or its promoters or directors on the basis of family relationship; who does not have any other relationship, whether pecuniary or otherwise, with the company or its subsidiary/ associated companies; who is not a member, director or officer of any stock exchange; and who is not a shareholder, director or officer of any member of stock exchange or an intermediary of the capital market (SEC, 2006).
2. We constructed our model such that performance in year t is depend on year t-1's governance structures and as such we introduced a lagged dependent variable into the right-hand side of the model, as Klein (1998) and Haniffa and Hudaib (2006).

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