Corporate Governance and Banking Performance: a Comparative Study between Private and State Banking Sector in Sri Lanka.

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Abstract

The main objectives of this study are to find out the relationship between corporate governance and banking performance and also find out the impact of corporate governance on banking performance. This study focused on four aspects of corporate governance namely; Board Size (BS), Board Diversity (BD), Outside Directors Percentage (OSDP) & Board Meeting Frequency (BMF). Banking performance has been measured through Return on Equity (ROE) and Return on Assets (ROA). The results revealed that all variables of corporate governance are positively correlated with ROE in state banks as well as, in private banks except BD and BMF other variables have strong negative relation with ROE, which is significant at 5percent level of significance. Similarly, except BMF other variables have negative relationship with ROA in state banks. Private Banks also show same relation except the variable BD. BD have strong negative relationship with ROA in state banks which is significant at 5 percent level of significance, but in private banks; positive relationship is denoted by BD which is not significant. Further corporate governance has a moderate impact on performance of both private and state banks.

Keywords: Corporate Governance, Banking Sector, Banking Performance

INTRODUCTION

Corporate governance can be defined as the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation (Wheelen and Hunger 2006). It also includes the relationship among the many players involved (the stakeholders) and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large (http://en.wikipedia.org). Ruin (2001) stated that corporate governance as a group of people getting together as one united body with task and responsibility to direct, control and rule with authority. On a collective effort, this body is empowered to regulate, determine, restrain, curb and exercise the authority given to it. However, corporate governance describes the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled (http://en.wikipedia.org).

Shleifer and Vishny (1997) argued that corporate governance is the way in which suppliers of finance to corporation ensure themselves of getting a return on their investments. Nonetheless, Melvin and Hirt (2005) described the concept of corporate governance as referring to corporate decision-making and control, particularly the structure of the board and its working procedures. It is also sometimes used very widely, embracing a company's relations with a wide range of stakeholders or very narrowly referring to a company's compliance with the provisions of best practice codes. In addition, Thomas (2002) described corporate governance in the ways and means by which the government of a company (the directors) is responsible to its electorate (the shareholders).Corporate governance can also be stated as the set of rules and procedures that ensure that managers do indeed employ the principles of value based management (Brigham & Ehrhardt ,2005).

On the other hand, Low (2003) viewed as corporate governance as dealing with mechanisms by which stakeholders of a corporate exercise control over corporate insiders and management in such a way that their interests are protected. Nevertheless, corporate governance comprises a country's private and public institutions, both formal and informal, which together govern the relationship between the people who manage corporations (corporate insiders) and all others who invest resources incorporations in the county (Oman, Charles, Fries, Steven & Buiter, & Willem, 2003).

Researcher focus is on the relationship between governance and performance. There are several reasons to expect that better governed banks may have more efficient operations and better performance. First, governance may reduce the incidence and amounts of related parties' transactions and other "self-dealing" practices. Since such transactions are usually sub-optimal from the efficiency point of view, the reduction in such transactions should translate into improved performance. Second, better governed banks may have lower cost of capital, especially if they employ subordinated debt financing. Third, better governance may translate into more efficient and streamlined operations, as the supervisory board and management functions are separated and modernized.

Corporate governance initiatives in Sri Lanka commenced in 1997 with the introduction of a voluntary code of best practice on matters relating to the financial aspects of corporate governance. Voluntary codes of best

practices on corporate governance were issued in 2003 (ICASL, 2003), and in 2007 corporate governance standards were made mandatory for all listed companies for the financial year commencing on or after 1st April 2008. This code covered the effectiveness of the board, separation of the position of CEO and the chairman, appointment of the chairman, non-executive directors, professional advice, director's training, directors responsibility for the presentation of financial statements, compliance reporting, internal control and committee structures for boards, including audit committee, and remuneration committees and nomination committees (Watawala, 2006).

The new Companies Act No. 7 was enacted in 2007 to keep abreast with prevalent international laws and to safeguard the interest of all stakeholders including directors, major shareholders, minority shareholders and creditors. The act introduced greater protection to minority shareholders, directors' duties, and transparency and accountability. The new Company Act No. 7 was based on Canadian, New Zealand and other modern practices. It became operative for all listed companies from 1st April 2007, and was mandatory from 1st April 2008. The civil war which ended in 2009 could have been expected to have had a major impact on economic growth. Instead, by 2007, the Sri Lankan economy recorded a growth rate of above 6 per cent for the third consecutive year. This raises the question: did the introduction of the corporate guidelines contribute to this result? If so, the changes in corporate governance practices would be expected to be significantly related to firm performance. The governance changes investigated in this study were the board structures.

In general, corporate governance is considered as having significant implications for the growth prospects of an economy, because best practice corporate governance reduces risks for investors, attracts investment capital and improves the performance of companies (Spanos, 2005). In Sri Lanka, effective corporate governance is considered as ensuring corporate accountability, enhancing the reliability and quality of financial information, and therefore enhancing the integrity and efficiency of capital markets, which in turn will improve investor confidence (Rezaee, 2009).

Cadbury (1992) pointed out corporate governance as "the system by which companies are directed and controlled". It is concerned with the duties and responsibilities of a company's board of directors to successfully lead the company, and their relationship with its shareholders and other stakeholder groups. It is also defined as a "process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively" (Rezaee, 2009).

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT
CORPORATE GOVERNANCE AND BANKING PERFORMANCE

Agency theory is the theoretical framework most often used by investors in finance and economics to understand the link between board characteristics and firm value. The arguments of Fama and Jensen (1993) are well known but, as a general statement, they propose a very important role for the board as a mechanism to control and monitor managers. The role of the board in an agency framework is to resolve agency problems between managers and shareholders by setting compensation and replacing managers that do not create value for the shareholders.

It is a general belief that good corporate governance enhances a firm performance. However, there have been some studies that have gone against this notion. For this reason it is inconclusive or inconsistent to say that corporate governance and firm performance are directly correlated. In a study by Akyereboah-Coleman (2008), the effect of corporate governance on performance of firms in Africa was carried out. He found a clear relationship between corporate governance and performanc.An empirical analysis was also carried out in Kenya, between the relationship of corporate governance and bank performance (Barako & Tower, 2007). The research was to empirically examine the relationship between ownership structure and bank performance (Barako & Tower, 2007: 139).Wolfgang (2003) good corporate governance lead to increased valuation, higher profit, higher sales growth and lower capital expenditure.

Board Size

There is a view that larger boards are better for firm value because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, some authors have advocated for smaller boards. Fama & Jensen (1983) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to coordinate, encourages free riding and poses problems. Smaller boards however reduce the possibility of free riding, and increase the accountability of individual directors. Hence there will be a positive or negative relationship between board size and firm value.

Board Diversity

One argument is that diversity increases board independence because people with a different gender, ethnicity, or cultural background might ask questions that would not come from directors with more traditional backgrounds. In other words, a more diverse board might be a more activist board because outside directors with nontraditional characteristics could be considered the ultimate outsider. However, a different perspective may

not necessarily result in more effective monitoring because diverse board members may be marginalized. Hence there will be a positive or negative relationship between board diversity and firm value.

Outside Directors Percentage

Best practice recommendations on corporate governance require boards to be composed of a majority of non-executive directors (ASX Corporate Governance Council 2003; Cadbury 1992; Hampel 1998). These recommendations were also incorporated in the code of best practice on corporate governance in Sri Lanka, because investors consider boards composed of non-executive directors as an important determinant of firm performance. Fama (1980) and Fama & Jensen (1983) consider the board as an important element of corporate governance and acknowledge the role of outside directors as monitors of management and providers of "relevant complementary knowledge".

In the code of best practice on corporate governance in Sri Lanka, board composition is also an important component of the board structure. The assumption is that an effective board comprised of a greater proportion of non-executive directors (Zahra & Pearce, 1989), is significant to firm performance. However, the principle A.5 of the code of best practice on corporate governance states that it is preferable for the board to have a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board's decision-taking. Furthermore, Principle A.5.1 states the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. The board should include at least two non-executive directors or such number of non-executive directors equivalent to one third of total number of directors, whichever is higher (ICASL & SEC of Sri Lanka, 2008).

Empirical evidence regarding the relationship between firm performance and board composition is mixed. Some studies find that there is a positive link between the firms' performance and its composition. Weir and Laing (2001) state that "if non-executive directors resulted in effective monitoring, their effectiveness would increase in line with their board representation". Consistent with the above, Baysinger and Butler (1985), found that in 266 US firms with higher numbers of outside directors on the board had a greater return on equity than the board with executive directors.

Ezzamel and Watson (1993) also found that non-executive directors were positively associated with profitability among a sample of UK firms. Contrary to the above and consistent with the stewardship theory, Kesner (1987) found a positive and significant relationship between the proportion of executive directors and returns to investors in an examination of the Fortune 500 companies. However in contrast, there is also a large body of research, which has found no relationship between composition and firm performance (Abdullah 2004; Chaganti, Mahajan & Sharma 1985; Daily & Dalton 1992, 1993).

Board Meeting Frequency

Board meeting frequency potentially carries important governance implications as it is less costly to adjust the frequency of its board meetings to attain better governance of the firm, than to change the composition of its board or ownership structure. The association between board meeting frequency and firm value remains unclear. In addition, the linkage between board activity and the degree of monitoring is difficult to isolate. Jensen (1993) argues that boards of well-functioning firms should be relatively inactive and exhibit few conflicts. Frequently scheduled meetings generate costs including managerial time, travel expenses, administrative support and directors' meeting fees. As a firm's performance declines, boards are likely to become more actively scrutinized by shareholders and are likely to meet more often to cope with the declining value. The benefits to increased board activity will include more time for directors to confer, set strategy and monitor management. Hence there will be a positive or negative relationship between board meeting frequency and firm value.

Firm Performance

Bank performance is the bank profitability and productivity in banking (Jeon and Miller, 2006). In addition, performance may also refer to the development of the share price, profitability or the present valuation of a company (Melvin and Hirt ,2005).A wide variety of definitions of firm performance have been proposed in the literature (Barney ,2002). Velnampy and Nimalathasan (2008) examined about firm size on profitability between Bank of Ceylon and Commercial Bank of Ceylon in Sri Lanka during ten years period from 1997 to 2006 and found that there is a positive relationship between Firm size and Profitability in Commercial Bank of Ceylon Ltd, but there is no relationship between firm size and profitability in Bank of Ceylon. Various studies identified the determinants of profitability (Islam and Mili, 2012, Velnampy, 2005 & 2005, 2013, Velnampy and Pratheepkanth, 2012, and Niresh and Velnampy, 2012) The existing literature on corporate governance practices has used accounting-based performance measures, such as return on equity (ROE) and return on assets (ROA), and market-based measures, such as Tobin's Q, as proxies for firm performance (Abdullah 2004; Bhagat & Black 2002; Daily & Dalton 1993).

RESEARCH QUESTIONS

Specifically, this study has been undertaken to explore the answers to the following research questions;

RQ_1: What are the dimensions that represent the corporate governance and banking   performance?

RQ_2: Is there any relationship between corporate governance and banking performance in private and state banks?

RQ_3: Do corporate governance have any impact on banking performance?

RESEARCH OBJECTIVES

Objectives of this study are as follows;

a)   To identify the dimensions that represent the corporate governance and banking performance.

b)   To identify the relationship between corporate governance and banking performance in private and state banks.

c)   To identify the impact of corporate governance on banking performance.

CONCEPTUAL FRAME WORK

After the careful study of literature review, the following conceptual model is formulated to illustrate the relationship between corporate governance and banking performance.
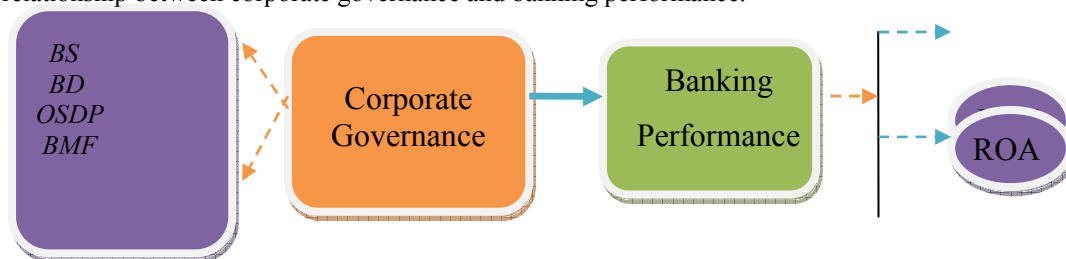
Source: Author Constructed

Figure-1: Conceptual Frame Work

Where,

BS – Board Size

BD – Board Diversity

OSDP – Outside Directors Percentage

BMF – Board Meeting Frequency

Above conceptualization model shows the relationship between corporate governance and performance of selected state and private banks.

HYPOTHESES DEVELOPMENT

H_1: There is a relationship between corporate governance and banking performance.

   H_{1a}: There is a relationship between corporate governance and ROE.

   H_{1b}: There is a relationship between corporate governance and ROA.

H_2: There is an impact of corporate governance on banking performance.

   H_{2a}: There is an impact of corporate governance on ROE.

   H_{2b}: There is an impact of corporate governance on ROA.

METHOD

Research methodologies of the present study are outlined below.

Sample

The sample for this study is the state and private sector banking organizations in Sri Lanka. For the research study two state banks [Bank of Ceylon (BOC) and Peoples Bank (PB)] and two private banks [Commercial Bank of Ceylon Plc (CBC) Hatton National Bank (HNB)] have been selected as per the convenience sampling.

Data Sources

In order to meet the objectives and hypotheses of the study, data is collected from secondary source mainly from financial report of the selected banks as the sources of samples data for the sample period from 2002 to 2011. Furthermore, this research only focuses on the directors' reports, balance sheets, and income statements in their annual reports.

Reliability and Validity of Data

Secondary data for the study is drawn from audited accounts [i.e., income statements (statement of comprehensive income) and balance sheets (statement of financial position)] of the concerned banks as fairly accurate and reliable. Therefore, these data may be considered reliable for the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these made in order to generate validity data for the present study. Hence, researchers satisfied content validity.

Test of Multi-co linearity

The variance inflation factor (VIF) is used to detect whether one predictor has a strong linear association with the remaining predictors (the presence of Multicollinearity among the predictors).VIF measures how much the

variance of an estimated regression coefficient increases if your predictors are correlated. The largest VIF among all predictors is often used as an indicator of severe Multicollinearity. Montgomery and Peck, 1982 suggest that when VIF is greater than 5-10, then the regression coefficients are poorly estimated.

Mode of Analysis

In the present study, we analyze our data by employing correlation and multiple regressions. For the study, entire analysis is done by personal computer. A well known statistical package like 'Statistical Package was used in order to analyze the data. The following two models are formulated to for Social Sciences' (SPSS) 16.0 Version was used in order to analyze the data. The following two models are formulated to measure the impact of corporate governance on banking performance.

ROE = $\beta_0 + \beta_1$ **BS** $+\beta_2$ **BD** $+\beta_3$ **OSDP** $+\beta_4$ **BMF** +e -- (1)

ROA = $\beta_0 + \beta_1$ **BS** $+\beta_2$ **BD** $+\beta_3$ **OSDP** $+\beta_4$ **BMF** + e-- (2)

     Where, $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4,$ are the regression co-efficient;

 ROE   = return on equity

ROA   = return on assets

BS   = board size

BD   = board diversity

OSDP = outside directors percentage

BMF = board meeting frequency

e   = error term

Results and Discussion

Correlation analysis is performed to find out the relationship between variables; BS, BD, OSDP, BMF, ROE and ROA .Table 1 provides the results.

Variable	ROE	ROA	BS	BD	OSDP	BMF
ROE	1					
ROA	-0.868** (0.001)	1				
BS	0.369 (0.294)	-0.627 (0.052)	1			
BD	0.523 (0.121)	-0.761* (0.011)	0.449 (0.193)	1		
OSDP	0.281 (0.432)	-0.471 (0.169)	0.124 (0.733)	0.860** (0.001)	1	
BMF	0.121 (0.740)	0.259 (0.470)	-0.136 (0.708)	-0.354 (0.316)	-0.457 (0.184)	1

Table 1(a): Correlation Matrix for State Banks

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

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

Table 1(a) shows the correlation values of state banks. Corporate governance is positively correlated with ROE, which is not significant as well as corporate governance is negatively correlated with ROA except BMF. In this case, BD shows strong negative relationship with ROA, which is significant at 5% level of significance.

Table 1(b): Correlation Matrix for Private Banks

Variable	ROE	ROA	BS	BD	OSDP	BMF
ROE	1					
ROA	0.768** (0.009)	1				
BS	-0.731* (0.016)	-0.242 (0.501)	1			
BD	0.417 (0.231)	0.446 (0.196)	-0.169 (0.640)	1		
OSDP	-0.744* (0.014)	-0.226 (0.530)	0.745* (0.013)	-0.185 (0.609)	1	
BMF	0.475 (0.165)	0.331 (0.351)	-0.187 (0.605)	0.267 (0.455)	-0.431 (0.214)	1

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

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

Table 1(b) shows the correlation values of private banks. BS and OSDP are negatively correlated with ROE, which is significant at 5% level of significance. Other variables BD and BMF are positively correlated which is not significant. Similarly corporate governance is correlated with ROA which is not significant.

Then a multiple regression analysis is performed to identify the predictors of banking performance as conceptualized in the model. Further the following models are formulated to examine the impact of corporate governance on banking performance. An Enter Method is used in the regression analysis and Table 2 provides the summary measure of the model.

Table 2(a): Predictor of Banking Performance – Model Summary (State Banks)

DETAILS	ROE	ROA
BS	-3.143 (0.992)	-.372 (0.632)
BD	55.256 (0.302)	-0.223 (0.123)
OSDP	-8.870 (0.588)	0.038 (0.365)
BMF	45.310 (0.528)	0.061 (0.733)
Constant	-1324.049 (t = -0.447;P = 0.674)	5.693 (t = -0.766; P = 0.478)
R	0.662	0.857
R2	0.438	0.734
Adjusted R^2	-0.012	0.521
Standard Error	362.38388	0.90811
F Value	.973 (0.497)	3.44 (0.104)

Note: Figure in the Parentheses indicate P- value

The specification of the four variables such as BS; BD; OSDP and BMF in the above model reveals the ability to predict performance (R^2 = 0.438 & 0.734 respectively). In this model R^2 value of above two performance ratios denote that 43.8% & 73.4% to the observed variability in performance can be explained by the differences in four independent variability, namely BS; BD; OSDP and BMF. The remaining 56.2% & 26.4% are not explained, because the remaining part of the variance in performance is related to other variables which are not depicted in the model.

An examination of the model summary in conjunction with ANOVA (F–value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables. For model 1- F value is 0.973 and respective P value is 0.497 which is statistically not significant. Again considering model 2- F value is 3.44 (P=0.104) which is statistically not significant. However, it should be noted here that there may be some other variables which can have an impact on performance of state banks, which need to be studied.

Table 2(b): Predictor of Banking Performance – Model Summary (Private Banks)

DETAILS	ROE	ROA
BS	-2.362 (0.273)	-.088 (0.736)
BD	.153 (0.380)	-.019 (0.402)
OSDP	-.058 (0.502)	.002 (0.881)
BMF	0.387 (0.477)	.035 (0.618)
Constant	36.662(t =2.244; P = .075)	1.314 (t = .623; P = .561)
R	0.854	0.519
R2	0.730	0.270
Adjusted R^2	0.513	-.315
Standard Error	2.22333	.28705
F Value	3.372 (0.107)	0.461 (.763)

Note: Figure in the Parentheses indicate P- value

The specification of the four variables such as BS; BD; OSDP and BMF in the above model reveals the ability to predict profitability (R^2 = 0.730 & 0.270 respectively). In this model R^2 value of above two performance ratios endorse that 73% & 27% of the variation in the dependent variable is explained by the independent variables of the model, namely BS; BD, OSDP and BMF. The remaining 27% & 73% variation in the dependent variables remain unexplained by the independent variables of the study.

An examination of the model summary in conjunction with ANOVA (F–value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables. For model 1- F value is 3.372 and respective P value is 0.107 which is statistically not significant. Again considering model 2- F value is 0.461 (P=0.763) which is statistically not significant. However, it should

be noted here that there may be some other variables which can have an impact on performance of state banks, which need to be studied.

Results of VIF

Variables	Variance Inflation Factor [VIF]	
	State	Private
Board Size	1.957	2.386
Board Diversity	7.405	1.095
Board Independence	6.684	2.801
Board Meeting	1.328	1.362

The Multi-co linearity test shows that all regression models have the variance inflation factor (VIF), a tool to verify whether one independent variable has a high correlation with the remaining independent variables ranging between 1 to 3 in private banks and 1 to 7.5 in state banks. Which is less than 10, thereby demonstrating that no Multicollinearity exists between independent variables in the regression models?

Hypotheses Testing

S.No	Tools	Hypotheses	Results
H_1	Correlation	There is a relationship between corporate Governance and banking performance.	Partially Accept
H_2	Regression	There is an impact of corporate governance on banking performance.	Partially Accept

CONCLUDING REMARKS

This study examined corporate governance and its impact on banking performance: A comparative study between private and state banking sector in Sri Lanka**.** The comparative analysis shows all variables of corporate governance are positively correlates with ROE in state banks as well as, in private banks except BD and BMF other variables have strong negative relation with ROE, which is significant at 5% level. Similarly, except BMF other variables have negative relationship with ROA in state banks. Private Banks also show same relation except the variable BD.BD have strong negative relationship with ROA in state banks which is significant at 5% level, but in private banks positive relationship is denoted by BD which is not significant. Further corporate governance has a moderate impact on performance of both private and state banks.

DIRECTIONS FOR FURTHER RESEARCH

The study is based on a simplistic model of corporate governance that has taken into account only four aspects, namely, BS, BD, OSDP and BMF. There are other factors, internal as well as external that also may affect state of corporate governance in an organization. A further study may be carried out including more factors in the model and by expanding its scope to other industries for better understanding and generalizing of the findings. Further, banking performance has been measured through Return on Equity (ROE) & Return on Assets (ROA). Other Key Performance Indicators (KPI) may also be introduced in the model for more authentic measurement of banking all round performance.

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