



Impact of Corporate Governance on Banks Performance

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ABSTRACT

Weak and ineffective corporate governance mechanisms in banks are pointed out as the main factors contributing to the recent financial crisis. Deep changes in this area are necessary to reinforce the financial sector stability. The purpose of this study is to survey the relationship between corporate governance mechanisms and Iranian listed banks performance during the years 2010-2015. The dependent variable of this study is financial performance of banks. That is a function of capital adequacy. According to CAMEL rating system, a high capital adequacy ratio is a symbol of healthy activity of banks and has a great weight on CAMEL rating. The independent variables are included the size of the board, the proportion of independent directors, the proportion of ownership of Institutional shareholders, the proportion of ownership of major shareholders and separation between CEO and chairman. After collecting data, we have used descriptive and regression model for analyzing data. The model for testing the hypothesis is multiple linear regressions. The result of this study according to multiple regression shows that only the proportion of ownership of Institutional shareholders have a positive impact on Capital Adequacy of banks and there is not any relationship between other independent variables and capital adequacy of banks.

Keywords: Corporate Governance, Board Size, Non-Executive Directors, Ownership Structure, Institutional Shareholders, Separating the Role of CEO and Chairman, Performance.

INTRODUCTION

Between 1980 to 1997, over 130 countries, comprising almost three fourths of the member countries of the International Monetary Fund (IMF) have experienced important problems with their banks (Sarkar & Sarkar, 2000). The fact that these crises occurred after implementation of far reaching reforms of the financial system revived long standing debates in Economics and Finance on role of bank regulation (Claessens, 2006; Claessens & Yurtoglu, 2013; Ehikioya, 2009). Banking system plays a very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services (Burton & Brown, 2014; Chakrabarti, Megginson, & Yadav, 2008).

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Given the important financial intermediation role of banks in an economy, their high degree of sensitivity to potential difficulties arising from ineffective corporate governance and the need to safeguard depositors' funds, corporate governance for banking organizations is of great importance to the international financial system and merits targeted supervisory guidance (Bawaneh, 2011; De Andres & Vallelado, 2008; Paces & Heremans, 2011). The Basel Committee on Banking Supervision (the Committee) published guidance in 1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organizations in their countries. This guidance drew from principles of corporate governance that were published earlier that year by the Organization for Economic Co-operation and Development (OECD) with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for financial market regulators and participants in financial markets (Morck, Wolfenzon, & Yeung, 2005; Mülbart, 2009). Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole (Nworji, Adebayo, & David, 2011; Van Greuning & Brajovic-Bratanovic, 2009). Poor corporate governance may contribute to bank failures, which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. In addition, poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a bank run or liquidity crisis. Indeed, in addition to their responsibilities to shareholders, banks also have a responsibility to their depositors (Committee, 1999; De Andres & Vallelado, 2008; To Thi, 2011).

The Specificity of the Corporate Governance of Banks

A bank's failure to follow good practices in corporate governance and the lack of effective governance are among the most important internal factors which may endanger the solvency of a bank. Corporate governance in banks differs from the standard (typical for other companies), which is due to several issues:

banks are subject to special regulations and supervision by state agencies (monitoring activities of the bank are therefore mirrored); supervision of banks is also exercised by the purchasers of securities issued by banks and depositors ("market discipline", "private monitoring"); the bankruptcy of a bank raises social costs, which does not happen in the case of other kinds of entities' collapse; this affects the behavior of other banks and regulators; regulations and measures of safety net substantially change the behavior of owners, managers and customers of the banks; rules can be counterproductive, leading to undesirable behavior management (take increased risk) which expose wellbeing of stakeholders of the bank (in particular the depositors and owners) (De Andres & Vallelado, 2008; Dragomir, 2010).

Between the bank and its clients there are fiduciary relationships raising additional

Relationships and agency costs problem, principal-agent is more complex in banks, among others due to the asymmetry of information not only between owners and managers, but also between owners, borrowers, depositors, managers and supervisors.

The number of parties with a stake in an institution's activity complicates the governance of financial institutions.

To sum up, depositors, shareholders and regulators are concerned with the robustness of corporate governance mechanisms. The added regulatory dimension makes the analysis of corporate governance of opaque banking firms more complex than in non-financial firms (Ciancanelli & Reyes-Gonzalez, 2000).

In the case of banks therefore, corporate governance needs to be perceived as a need of such conduct of an institution, which would force the management to protect the best interests of all stakeholders and ensure responsible behavior and attitudes (Ciancanelli & Reyes-Gonzalez, 2000). Corporate fairness, transparency and accountability are thus the main objectives of corporate governance, taking into account the corporate "democracy", which is the broad participation of stakeholders (Ciancanelli & Reyes-Gonzalez, 2000).

One must have in mind that there is no one model of corporate governance adaptable to all banks. Other goals, and therefore supervisory systems, will be in banks: private, cooperative and state; in the local and global banks; universal banks and investment (etc.); though priorities remain the same.

In the banking sector corporate governance is therefore a way of business and affairs of the bank by the management and the board, affecting how they (Gordon & Natarajan, 2007; Kirkpatrick, 2009; Macey & O'hara, 2003).

Define the objectives and goals:

Lead current bank activities:

Fulfill the obligation of accountability to shareholders and take into account the interests of stakeholders; apply the requirement to operate safely and to ensure a good financial situation and compliance with applicable regulations; protect the interests of depositors (and other clients and creditors) (Macey & O'hara, 2003; Marcinkowska, 2012).

Shortcomings in the governance of large financial groups have indicated that these may trigger (indirectly) systemic risks. Regulators and financial supervisors take action to ensure an individual bank's stability; in the case of systemically important banks this would result in the pursuit of overall financial stability. The main issues of corporate governance matters with specific systemic impact are: the "gatekeepers" (esp. auditors and credit rating agencies), corporate values and codes of conduct of banks, risk management and internal governance of banks managerial incentives to act in an appropriate manner, accounting (and valuation) rules (Gordon & Natarajan, 2007).

Moreover, there is some skepticism about the effectiveness of the 'comply or explain' approach to corporate governance (Gordon & Natarajan, 2007).

Analysis of the statements on the application of corporate governance indicates that a vast majority of companies did not present an explanation of the reasons to withdraw from the application of certain rules or the clarification is made with low quality information. This confirms the need for support mechanisms employed by the regulator and the requirement that companies monitor statements made by the regulator and take an appropriate response to the lack of or insufficient explanation (Blinder, 1999; Gordon & Natarajan, 2007). As pointed out by the European Commission, the "comply or explain" approach would work much more effectively if specific monitoring bodies (such as regulatory bodies for securities, stock exchanges or other bodies) were entitled to check whether the available information (in particular the explanation) has an appropriate informative value and is appropriately broad. It is emphasized, however, that these institutions should not interfere with the content of the information disclosed or evaluate the solutions adopted by the company – it should still be a task left to the market (Gordon & Natarajan, 2007; Shekhar & Shekhar, 1974; Siddiqi, 2006).

Theoretical Framework

1. Board size

Board size refers to the number of directors in the board. The number of board members is different from country to country or corporate to corporate, because of the differences in culture,

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regulation, and corporate ownership structure (Tarullo, 2008). According to CG Principles, to obtain an effective monitoring, the board should be adequately sized. In Iran, Law on Enterprises regulates that number of directors on boards cannot be less than 5 members for public companies.

In addition, empirical analyses suggest a positive relationship with optimal board size ranging from 5 to 10 members.

2. Board Independence

Independence of the board is an important point in CG Principles that repeatedly examined in many researches. Today, it is now widely recognized that independent boards play an important role in a sound governance structure (Tarullo, 2008). Refer to OECD CG Principles; the boards should be comprised of at least a majority of “independent directors”.

Boards should consider assigning a sufficient number of independent board members capable of exercising independent judgment to task where there is a potential for conflict of interest⁶. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, reviewing of related party transactions, nomination of board members and key executives and board remuneration (Johnston, 2004).

When investigating the composition of board of directors, we can see how different the companies describe the definition of “independence” which is disclosed and observed in its annual proxy statement.

3. Ownership concentration

Transparency of ownership structure is more and more important. As discussed, good CG used to reduce the agency problem between owners and managers and the conflicts of interests resulting from the separation of ownership and control.

We cannot deny that agency problems have been created from conflicts between interests of owners and agent or poor corporate governance implication. Ownership concentration shows how concentrated in possession of outstanding shares, for example a concentrated ownership indicated a few owners hold a large portion of shares. Therefore, it is argued that concentrated ownership can reduce the agency problems since few large owners will monitor the firm more closely and efficiently. However, in case just one or two members hold a very large portion of shares, they have tendency to act according to their own objectives rather than minority shareholders and can cause the lower value of firm.

It is not strange when Mehran, Morrison, and Shapiro (2011) believe that in companies with high ownership concentration, the most pervasive agency conflict in the firm is between controlling shareholders and minority shareholders, the so-called horizontal agency problem⁷. In addition, boards of companies with high ownership concentration will tend to be mostly comprised of directors who represent the owner manager's interests, thus being unable to deal with the specific agency problem adequately.

4. Separating the role of CEO and chairman

It seems that every year calls ring out louder and louder for boards to separate the roles of CEO and chairman. Large companies from Wells Fargo (WFC) to News Corp. (NWSA) have faced shareholder proposals demanding that they replace their CEO with an independent director in the role of chairman.

Advocates of splitting the positions argue that an independent leader will aid the board in more effectively monitoring the CEO's actions and performance. Critics of the combined CEO/chairman role include institutional investors, policymakers, and a preponderance of corporate governance experts and advisory firms. Many executives disagree, however, arguing that such a structure creates unnecessary confusion and hurts unity of leadership.

5. CAMEL rating system

The CAMELS Rating System is a set of institutional assessment indexes of credit standing and operation designed by American monetary authority. Because the beginning letter of five indexes are “Capital Adequacy” “Asset Quality” “Management” “Earnings” “Liquidity”. The CAMEL ratings are accepted by public owing to its efficiency. Based on CAMEL system, the international organizations add other indicators later including the assets quality, deposit structure, human resource, earning performance and capital adequacy. It proved that the framework of CAMEL is classical and used widely in banking area .

The CAMEL rating system divides the competitiveness of commercial banks into five levels. For capital adequacy, it is a proportion of capital and risk assets. For the rate of problem loans and capital. For the third assessment, we need to consider the management level and staff qualification, in addition, how the bank to handle emergent events and decision of BOD is important. The banks need complete the inner control and perfect innovation for attracting customers. For the requirement of liquidity, the banks which meet the demand of deposit the money and granted a loan any time .

Through five individual assessments, a comprehensive evaluation of CAMEL ranks the commercial banks at certain level. The features of CAMEL rating system are assessed by the single item, then the system get five indicators to be integration and work out the final result. At the same time, it combines qualitative analysis and quantitative analysis. The model focuses on the ability of risk management and put other factors into consideration such as the scale of bank and financial risk. The result will provide clear information about the performance of commercial banks(Xin, 2009).

METHODOLOGY

Since the target of this paper understands the relationship between corporate governance mechanisms with banks performance, I have to select limit but efficient data from the largest in access bank society in Iran. Because there are not Transparency in Disclosure and access to annual reports of governmental banks of Iran and to avoid the selection bias, I choose Iranian listed banks during the years 2010-2015. The data has been collected from the Annual Reports of the Bank, .the annual reports are provided from the official website of banks, central bank library and stock exchange library. For calculating bank performance I used capital adequacy ratios as dependent variable. The ratio which is used for the evaluation the capital adequacy of banks and description of independent variables are shown in the following table.

Table 1. Variables description

Independent variables	Description
Board size	Number of the directors on board
Non-executive directors	ratio of number of non-executive directors to all directors in board
Major shareholders	ratio of ownership of Major shareholders(who has more than 5percent share of the company)
Institutional shareholders	ratio of ownership of Institutional shareholders
separating the role of CEO and chairman	Separated is equal to1 Not separated is equal to 0
Dependent variables	Description
capital adequacy	(Tier 1 capital + Tier 2 capital) /risk weighted assets ²²

According to research theory, two main kinds of research approaching are deductive and inductive. In this study, I form up the research objections from the existing theory OECD

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Principles and Basel committee guidance, which have been developed years ago and try to find out if there is any association between board size, board composition, board independence, ownership concentration and firm performance. Hence, in this case the deductive approaching is an appropriate way to test the specific hypotheses and answer the research questions.

Besides, a quantitative approach is an appropriate way in this study since it refers to the systematic empirical investigation by using statistical, mathematical models. Moreover, quantitative method is used to validate hypotheses if they are true or not.

Almost conclusion withdraws from the results of analysis using basic descriptive statistics and multiple regression analysis.

After the step of data collection, we conducted a statistical analysis of the data by using

E-Views program. The purpose of the E-Views analysis was to test if the financial performance of banks, measured by camel ratios, relates to the corporate governance mechanisms. Furthermore, tow statistical models were conducted: Descriptive statistics and multiple regressions. Now we set the empirical conclusions based on the statistical analysis when studying the relation between CG structures and bank performance. Results of CG situation in Iranian listed banks from descriptive statistics and multiple regression analysis are considered in turn.

RESULT

Table 2. Summary of description statistics of independent variables

Variables	N	Minimum	Maximum	Mean	Std. Deviation
Board size	60	4	11	6.18	1.66
Non-executive directors	60	0	0.67	0.18	0.21
Major shareholders	60	7.43	100	57.16	30.21
Institutional shareholders	60	32	100	79.15	21.42
separating the role of CEO and chairman	60	0	1	0.75	0.44

The description statistics of independent variables are summarized in Table 2. As we can see, the number of directors in board is about 6 people on average. The number of directors in board varies in a wide range from a minimum of 4 to a maximum of 11 which is not according the law in Iran.

The ratio of number of non-executive directors to all directors in board is about 18 percent on average. The ratio varies in a wide range from a minimum of 0 to a maximum of 67 percent which shows the low emphasis of independent board in Iranian private banks.

The ratio of ownership of Major shareholders is about 57 percent on average. The ratio varies in a wide range from a minimum of 7 to a maximum of 100 percent which shows the low distribution of shareholders in Iran and grate ownership-concentration in Iranian private banks.

The ratio of ownership of Institutional shareholders is about 70 percent on average. The ratio varies in a wide range from a minimum of 32 to a maximum of 100 percent which shows that most of the Iranian private banks are governed by Institutional shareholders.

Dependent variables

Table 3. Summary of description statistics of dependent variable

variable	N	Minimum	Maximum	Mean	Std. Deviation
Capital Adequacy	60	4.90	24.70	11.83	4.73

The description statistics of dependent variable are summarized in Table 4-1. As we can see, the capital adequacy is about 12 percent on average. The ratio varies in a wide range from a minimum of 4.9 percent to a maximum of 24.7 percent which is almost the above percentage required by Basel commitment.

Multiple Regression Analysis

The results from the linear regression model enabled the measurement of the relationship between dependent variable and several independent variables and test the hypotheses that were deducted earlier from the theoretical framework of this study. If the null hypothesis is rejected, the test gives sufficient statistical evidence that the relationship between dependent and independent variables is significant. On the other hand, if a null hypothesis is not rejected, the relationship between the studied variables is influenced by other factors than those that have been suggested. In order to determine whether one should reject or confirm the null hypothesis we have looked at the p-values that point the significance of the relation (To Thi, 2011).

As Saunders, et al. have argued, that it is very difficult to obtain a significant t-statistics with a small sample size. However, the impact of the sample size decreases when more than 30 observations are included in the study. In current study there are 60 cases, which is close to the critical 30 observations. Even though, the sample size was relatively small, it was assumed to be normally distributed.

Regression Results for Capital Adequacy

The regression model includes independent variables mentioned before such as the number of board directors, the number of independent directors, ratio of shares held by Institutional shareholders, separating the role of CEO and chairman and ratio of shares held by major shareholders the result of regression analysis for the effect of independent variables on capital adequacy are shown in the following table:

Table 4. Regression results for capital adequacy

Variable	Coefficient	t-Statistic	Prob.
constant	5.130752	0.604352	5.130752
Board size	-0.283419	-0.414224	-0.283419
Non-executive directors	-0.314981	-0.109986	-0.314981
separating the role of CEO and chairman	-0.677124	-0.346614	-0.677124
Major shareholders	-0.035175	-1.003951	-0.035175
Institutional shareholders	0.141488	2.270476	0.141488
AR(1)		0.827631	

Regression result for bank performance based on capital adequacy shows that only major shareholders is negatively related to bank performance, so hypothesis 1,2,4 and 5 is refused and hypothesis 3 is accepted.

CONCLUSION

The scale irregularities found in banks and financial markets that led to the financial crisis have brought up the need for in-depth analysis of all aspects of their operation, in particular the efficiency of corporate governance.

Our empirical findings show that corporate governance mechanisms enhanced bank performance that is referred as camel rating, however, the differences between the impact degrees of independent variables is considerable. The major shareholder has impact on the bank performance measured by capital adequacy which is on same line by corporate governance codes. According to CG codes the essence of major shareholders can assist companies to improve their performance because they have greater influence and power to direct companies. The minority shareholders usually have not incentives, knowledge and power in order to participate on controlling and directing companies, so they actually are forced to follow major shareholders,

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since as our empirical research shows major shareholder has a significant impact on the performance of banks .

However, this study indicates that the other independent variables are not correlated to capital adequacy of banks; it is argued that concentrated ownership and independent board can reduce the agency problems since these can improve performance of banks.

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