International Journal of Science and Research (IJSR)
ISSN: 2319-7064
ResearchGate Impact Factor (2018): 0.28 | SJIF (2018): 7.426

The Impact of Corporate Governance on the Performance of Banking Sector

Shokhrukhjon Yuldashov[1], Wei Wang[2]

Engineering Simulation Calculation and Statistics, Zhejiang University of Science and Technology, Hangzhou 310023, China

Abstract: ***The purpose of this study is to examine the current practices of corporate governance in banking industry. Corporate governance is the system by which companies are directed and controlled. Furthermore, a bank serves several conflicting interests, from equity holders, to borrowers or depositors and good governance is important for balancing those interests. Good corporate governance is critical for Banking Industry because with good corporate governance, the bank could preventive the banks from financial fraud that could lead to financial distress and bankruptcy. Moreover, the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the banks. Corporate governance is the system by which companies are directed and controlled.***

Keywords: Corporate Governance, Bank Performance, Board size, Stakeholders, Governance Structure.

1. Introduction

Most of the existing literature on corporate governance has focused on firm performance and very limited researches have been paid attention to the corporate governance of banks. However, the corporate governance on banks is very complex and unique compared to non- financial firms for different reasons. First, banks are large organizations and corporate governance is necessary for banks to perform effectively. Second, according to Levine the banks play an important role on economic development and growth [6].

Corporate governance is a system used to direct and control an organization. It includes relationships between, and accountability of, the organization's stakeholders, as well as the laws, policies, procedures, practices, standards, and principles which may affect the organization's direction and control. Corporate governance has become one of the most topical issues in the modern business world today. Corporate governance mechanisms are the methods employed, at the firm level, to solve corporate governance problems [4].

Bank governance was altered tremendously since last several decades principally due to bank ownership changes, such as mergers and acquisitions.

Banking industry very rapidly generally accompanied with the increasing complexity of business activities of the bank, resulting in increased risk exposure of banks. Good corporate governance in the banking industry is becoming more important for today and the days to come, given the risks and challenges faced by the banking industry will increase [2].

In order to improve the performance of the bank, protect the interests of stakeholders and improve compliance with laws and regulations as well as the code of conduct which applies in general to the banking industry, banks are required to conduct its operations based on the principles of good corporate governance.

Good corporate governance of the bank is important to the bank soundness itself and the macroeconomic stability of the nation. Thus, corporate governance becomes one of the popular research topics in banking industry that draw the worldwide attention because the quality of bank's corporate governance will affect the bank's performance. On top of that, the bank admits that governance is the foundation for establishing trust and promoting engagement between a company and its stakeholders [1]. The application of risk management will also encourage better compliance with the principles of good corporate governance in a bank, especially in order to improve the performance and competitiveness of the bank itself [2].

Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness is a key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole.

The primary objective of corporate governance should be safeguarding stakeholders' interest in conformity with public interest on a sustainable basis. Among stakeholders, particularly with respect to retail banks, shareholders' interest would be secondary to depositors' interest [7].

Principles for good corporate governance in baking sector

- Transparency: Openness in expressing material and relevant information;
- Accountability: Clarity of function and implementing accountability;
- Responsibility: Bank management conformity with the legislation;
- Independency: Professional banking without influence and pressure;
- Fairness: Fairness and equity in shareholders rights;

2. Literature Review

Bank governance was altered tremendously since last several decades principally due to bank ownership changes, such as mergers and acquisitions.

Corporate governance focuses on the control systems and structures by which managers are held accountable to the bank's legitimate stakeholders. Traditional finance literature has indicated several mechanisms that help solve corporate governance problems. There is a consensus on the classification of corporate governance mechanisms to two categories: internal and external mechanisms. However, there is a dissension on the contents of each category and the effectiveness of each mechanism [4].

Adams and Mehran have used a sample of 35 publicly traded BHCs in the United States over a period of 1986–1999 to examine relationships between governance and performance. They too report that board size is positively correlated with performance. Other recent studies attempt to further probe the issue of corporate governance in Asia. Boubakri examine corporate governance features of Asian firms that have been newly privatized. Chinese literature on the topic seems to be more mature as compared to other Asian countries [3].

2.1 Hypothesis Development

Past research has pointed out that the board of directors and corporate governance in general will tend to play a far more significant role in determining the performance of firms in the banking sector than in industries that are not regulated to that effect. This accrues out of a variety of factors. Primarily, the lack of transparency in the nature of the business exacerbates the information asymmetry in this sector and makes monitoring even more difficult. Further, regulators can always be perceived as additional third-party interveners running after their own interests, making regulation a governance problem rather than an administrative necessity [3].

3. The Origin of Corporate Governance Theory

Good corporate governance of banks requires prudential risk-related regulation and attention to conflicts of interest and competition issues, particularly given the clear information advantage of banks over their retail customers. Banks are prudentially regulated and highly levered compared to other companies and hence bank governance deserves special attention.

Farinha mentions that the term corporate governance is a relatively, although the issues it addresses have been around for much longer, at least since Berle and Means and the even earlier Smith. Berle and Mean, corporate governance is an idea to separate the ownership from control. In early stage of corporate governance development, Berle and Mean's idea is to separate the power between the state and a wide range of institutions, in order to create a public trust to government's institutions [1].

In short, corporate governance origin purpose is to prevent principal's interest through establishes performance monitoring mechanism for the agent. Corporate governance has created in order to ensure the firm performance in line with principal's interest.

3.1 The Various Definition of Corporate Governance

There is various definition of corporate governance. Cocris and Ungureanu stated that corporate governance is defined and practiced differently throughout the world, depending upon the relative power of owners, managers and providers of capital.

Garvey and Swan describe corporate governance as a corporation's contract that determines the relationship between firm's top management and executives. Cotelli states corporate governance as a regulation that determines equity allocation among insiders, including directors, CEOs, executives and other individual. Hart mentions that corporate governance is needed when there is an agency problem or conflict of interest issue; and when that problem could not dealt through a contract. Shleifer and Vishny define corporate governance as the deal to ensure the suppliers of finance to firms will get a return on their investment. Okougbo (2011) offers different definition of corporate governance as a set of process, customs, policies, laws, and institutions affecting the way in which a corporation is directed, administered, and controlled.

Specifically in banking industry, Basel Committee on Banking Supervision (2015) states the definition of corporate governance as: 'A set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority is allocated and how corporate decisions are made [1].

3.2 Corporate Governance Problems of Banks

The typical principal-agent problem between managers and shareholders exists in every firm. The agency problem of banks however is likely to be particularly acute. Because this problem is raised to a new dimension in many aspects in the banking context, due to a number of institutional characteristics particular to banks [8].

3.3 Governance Structure

The banking governance regulation is might be different from other unregulated firms; therefore the board of directors in banking industry plays a crucial role in its governance structure (Adams and Mehran, 2003). Jensen and Meckling (1976) on Adams and Mehran (2003) argue that board structure, ownership structure, and compensation structure are determined by one an another as well as by range of variables, such as risk, real and financial assets, cash flow, firm size and regulation. Financial risk is a key factor for improving corporate governance in banking industry; furthermore, Ungureanu suggests that banks must set their corporate objectives and risk profile with the aim of protecting banks in all aspects [1].

The purpose of governance mechanism is to overcome the information asymmetric problem that requires a higher disclosure of information to their shareholders and creditors. The potential of information asymmetric problem is higher on banking industry compare with other industries. Therefore, banks develop monitoring and controlling mechanism based on its governance mechanism.

3.4 International Corporate Governance Regulations

In addition to each country's national accounting and auditing standards and principles, there are international standards and principles that may be applied in many countries as follows: 1- The U.S. GAAP and European IFRS which allow managers various methods to choose from regarding their recognition of financial reporting elements. However, in order to make their bank performance look better than what it really is, the managers may abuse such choice advantage and thereby increase the information risk for users through falsification of values, concealing fraud, or hiding important information that should be disclosed; and 2- The Basel Accords (Agreements) issued by the Basel Committee on Banking Supervision (BCBS) which does not enforce its recommendations although most countries implement them. Three Accords have been published by the BCBS so far, as follows: Basel I of 1988 regarding the minimum capital requirements for banks; Basel II of 2004 and its updates during 2005-2009 with respect to capital requirements, supervisory review, and market discipline; and Basel III which is agreed upon by the BCBS in 2010-2011 as regards capital adequacy, stress testing, and market liquidity risk [4].

3.5 Interested Stakeholders

Corporate governance parties include internal parties, such as the organization's shareholders, internal auditors, audit committee, board of directors, CEOs, CFOs, and other executives and managers; and include external parties, such as customers, suppliers, external auditors, stock exchanges, and government authorities. Other parties who have a stake in the organization may also include the organization's employees, creditors, and the community at large. The governance chain depends on the size of the organization. In a small family business, it is very simple, consisting of shareholders, board of directors, and managers; some of whom may be family members. In large publicly-held organizations, the chain may include managers, senior executives, executive directors, board, investment managers, trustee of funds, and beneficiaries [4].

4. Bank's Performance

Good corporate governance tends to ensure sound corporate performance by providing protection for shareholders interest. Investors and lenders will be more willing to put their money in firms with good governance because they will face lower costs of capital, which is another source of better firm performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and long lasting than those with firms with less effective governance [5].

4.1 Bank Corporate Governance in Practice

Since banks pose unique corporate governance problems, the corporate governance of banks should address these issues. This means that bank governance would be different from that of non financial institutions by going beyond addressing the typical principal agent problem. This section reviews the practices of bank governance from external mechanisms, ownership structure, regulation and supervision, and internal mechanisms [8].

4.2 Relationship between Board Size and Bank Performance

Although board size is one of the important mechanisms of good corporate governance but there is a mixed opinion among researchers regarding size of the board and bank performance. Some researchers say that there is a negative relationship between board size and bank performance, where as other researchers suggest that there is a positive relation between board size and bank performance. It is because, in a situation where board size is small, their likeminded persons are appointed as directors and abuse the rights of minor shareholders. In spite of having difficulties to manage a large board in banks which causes delays in executing important decisions and creates hidden costs for banks but at the same time it is very beneficial for firm performance where the rights of minor shareholders are at stake. Again, some researchers found that bank performance is unaffected by size of the board (Holthauson and Larcker, 1993). This finding is also supported by Forbes and Milliken, (1999).

4.3 Relationship between Board Independence and Bank Performance

One of the conditions of the BSEC is that at least one fifth of the total number of directors in the company's Board shall be independent. Presence of independent directors in board can bring independence in decision and able to eradicate agency problem and curb managerial self-interest therefore mass shareholders interest can be protected. Board independence is negatively related to bank performance stated that the result for relationship between board independence and firm performance are mixed. Dehaene unveiled that a proportion of independent directors are positively correlated with ROE among Belgian companies. This finding is supported by Byrd. As he pointed out a significant positive effect of independent directors on firm performance. Ramdani and Witteloostuijn claimed that board independence only has an effect on firms with average performance; firms with below average performance are not affected. On the other hand, Chen claimed that the percentage of independent directors on boards has little impact on overall firm performance. Inversely, research by Hermalin and Weisbach found no evidence that board independence affects firm performance. This result was consistent with another study conducted by Klein.

4.4 Relationship Between Internal Audit Committee and Bank Performances

Many of the internal auditors suggest that there is a correlation between internal audit function and firm's performance. A group of researchers suggest that the audit committee plays a large role in consolidation of financial control within a company**.** Audit committees help to figure out appearance of errors in earnings management, which otherwise may lead to inaccurate financial statements. The effective internal audit can also safeguard the firm from potential losses and increase level of shareholders value, internal audit tends to achieve better returns by improving higher firm performance.

4.5 Relationship between Capital Adequacy Ratio and Bank Performances

In the banking industry, capital is usually regulated by an apex bank to mitigate bank solvency problems. Customers are more concerned with the sufficiency of banks' capital for the safety of their deposits. Capital adequacy ratio helps a bank to absorb its realized and anticipated losses (risk) and improve their return on capital [5].

5. Conclusion

Corporate governance is often associated with banks. They can benefit from this practice. Corporate governance consists of rules that direct the roles and actions of key people rather than processes. Corporate governance rules focus on creating better management and fewer ethical or legal problems. A corporate governance program can boost banks reputation. If the banks publicize with corporate governance policies and detail how they work, more stakeholders will be willing to work with them. This can include lenders who see banks have strong fiscal policies and internal controls, charities. The practice of sharing internal information with key stakeholders is known as transparency, which allows people to feel more confident. Moreover, corporate governance limits the potential for bad behavior of employees by instituting rules to reduce potential fraud and conflict of interest. For instance, the company might draft a conflict of interest statement that top executives must sign, requiring them to disclose and avoid potential conflicts.

Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Also, cooperating helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Corporate governance in banks also boosts the confidence of investors. It reduces the risk of capital outflow from an economy and at the same time, increases the flow of capital in the economy.

References

[1] Ki Hajar Dewantara, Kota Jababeka, Cikarang Baru, "Corporate Governance in Banking Industry: An Explantory Study" , Research journal of Finance and Accounting, Vol. 7, No. 6, 2016.
[2] DR. Thobby Wakarmamu, M. Si, " The Role of Good Corporate Governance Banking Sector in Supporting Risk Management Principles as the Implementation of Prudential", European Journal of Business and Management, Vol.7, No. 35, 2015.
[3] Anshuman Kumar, Yatin Nihalani, "The Effect of Corporate Governance on the Performance of Indian Banks ", International Journal of Innovative Research & Development ", Vol. 3, Issue 8, August, 2014.
[4] Ahmed Mohsen Al-Baidhani, " The Effect of Corporate Governance on Bank Performance : Evidence from the Arabian Peninsula" , Conference Paper, January 2015.
[5] Fahmida Akhter, Mohammed Rafiqul Alam, " Impact of Corporate Governance on Performance of Commercial Banks in Bangladesh" , The Cost and Management, volume -45, October, 2018.
[6] Salma Belhaj, Cesario mateus, " Corporate Governance Impact on Bank Performance Evidence from Europe " , Corporate Ownership & Control, Volume 13, 2016.
[7] Guidelines, " Corporate Governance Principles for Banks " July 2015.

[8] Wei Sun , " China's Banking Reform: A Corporate Governance Perspective".
[9] Blair, M. M. (1995), Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century, The Brookings Institution, Washington, D. C.
[10] Donaldson, L. (1990), `The Ethereal Hand: Organisational Economics and Management Theory', Academy of Management Review, 15 (3), 369-381.
[11] Tricker, R. I. (1994), International Corporate Governance, Simon & Schuster, Singapore.
[12] Shleifer, A. and Vishny, R. W. (1997), `A Survey of Corporate Governance', Journal of Finance, 52,737-783.
[13] Monks, R. A. G. and Minow, N. (1995), Corporate Governance, Malden, Mass; Blackwell Publishers. Oxford.
[14] Keasey, K., Thompson, S., and Wright, M. (eds.) (2005), Corporate Governance: Accountability, Enterprise and International Comparisons, Wiley, Chichester.
[15] OECD (1999), Principles of Corporate Governance, Paris.
[16] World Bank (1999), Corporate Governance: Framework for Implementation, www. worldbank. org.
[17] Diamond, D. W. (1984), `Financial Intermediation and Delegated Monitoring', Review of Economic Studies, (51), 393-414.
[18] Saunders, A. and Sommariva, A. (1993), `Banking Sector and Restructuring in Eastern Europe', Journal of Banking and Finance, 17,931-957.
[19] Prowse, S. (1995), `Alternative Methods of Corporate Control in Commercial Banks', Federal Reserve Bank of Dallas Economic Review, Third Quarter.
[20] Gorton, G. and Rosen, R. (1995), `Corporate Control, Portfolio Choice and the Decline of Banking', Journal of Finance, (50), 1377-1420.
[21] Caprio, G. Jr. and Levine, R. (2002). `Corporate Governance of Banks: Concepts and International Observations', Paper presented at the Global Corporate Governance Forum Research Network Meeting.
[22] Macey, J. R. and O'Hara, M. (2003 a), `The Corporate Governance of Banks', Economic Policy Review, (April), 91-107.
[23] Levine, R. (2003), `The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence', The World Bank, Policy Research Working Paper 3404.
[24] Prowse, S. (1997), `The Corporate Governance System in Banking: What Do We Know? ', Banca Nazionale del Lavoro Quarterly Review, (March), 11-40.