Corporate Governance and Performance of Banking Sector in Pakistan

Ramiz ur Rehman and Inayat Ullah Mangla

Abstract

This paper investigates the impact of corporate governance variables on the financial performance of banking sector in Pakistan. For this purpose, the data of financial performance and corporate governance variables of thirty banks are used for the period of 2001-2009.The panel regression analysis is applied to determine this effect, firstly for the whole banking sector, and secondly for different types of banks. These types are categorized on the basis of their ownership and banking practices. The results show that there is a significant impact of corporate governance variables on the performance of overall banking sector in Pakistan. But there is no significant impact of corporate governance practices on the performance of foreign banks

Introduction

Corporate Governance refers to the way an organization is directed, administrated or controlled. It includes the set of rules and regulations that affect the manager's decision and contribute to the way company is perceived by the current and potential stakeholders. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as; boards, managers, shareholders and other stakeholders and spells out the rules and procedures and also decision making assistance on corporate affairs. By doing this, it also provides the structure through which the company's objectives are set and the means of obtaining those objectives and monitoring performance. Corporate governance may be the ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors.

Given the state of the economy of Pakistan in 2010, troubled as it is; ideally it would be more desirable to look at the governance issues at macro level for Pakistan. As a famous economist, Dr Shahid Javaid Burki- a long observer of Pakistan's economy has recently stated "Pakistan can generate a greater bounce in its economy than India by creating better governance. It has occurred before in the country's difficult economic history and could happen again." (Improved Governance: Dawn, 12th, October 2010).

However, as a starting point , in this paper we look at closely the governance issues for the financial sector , a sector which has played a significant role till recent years in economic activity of Pakistan.

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(Rehman et al ;2010) have looked at the issue of corporate governance in Chemical and Pharmaceutical sectors of Pakistan and found that there is a significant impact of corporate governance on the shareholder's returns in pharmaceutical sector of Pakistan. Corporate governance has become an issue of global significance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations. In Pakistan, the first Code of Corporate Governance for Pakistan was finalized and issued by SECP in March 2002. Then it was subsequently incorporated in all the listed companies of three stock exchanges in Pakistan. In 2004, SECP took the first step to establish the Pakistan Institute of Corporate Governance in public private partnership.

Literature Review

According to" A Survey of Corporate Governance Practices in Pakistan, 2007", conducted by: International Finance Corporation and SECP, 92% respondents prepare annual "statement of Ethics and Business Policy", 48% had "vision and Mission Statement", and none of the respondents have Code of Corporate Governance. On the other hand, it was also found that 50% of the corporations in Pakistan did not include non-executive directors in their board of directors, 54% have not introduced transaction administration procedure, 53% have not implement a formal remuneration system, and 55% did not have corporate governance improvement plan. Whereas, 31% respondents did not identify the barriers to improve the corporate governance, 69% identified the barriers, 42% had non availability of qualified staff to implement and 21% did have the claim that corporate governance produces sensitive information that cannot be shared with the competitors.

According to (Maria Mahar and Thomas Anderson ;2008) there are some weaknesses, strengths and economic implications associated with corporate governance systems. It is widely believed that good corporate governance is an important factor in improving the value of a firm in both developing and developed financial markets. However, the relationship between corporate governance and the value of a firm differs in emerging and mature financial markets due to disparate corporate governance structures in these markets resulting from dissimilar social, economic and regulatory conditions in these countries. There is a need to understand the differences which affect the value of a firm for academic investigations, financial and management practices and public regulation of corporations and markets. The variables used by (Kashif Rashid; 2008) price to book value ratio, market capitalization, gearing ratio, return on total assets, shareholder's concentration (agency cost), CEO duality, board size, and judicial and regulatory authority efficiency.

(Burki and Ahmad; 2007) explored the changes of corporate governance in Pakistan's banking sector and its impact on their efficiencies. They introduced dummy variables as a proxy of corporate governance changes in the banking sector of Pakistan. The result suggested that there was an impact of corporate governance changes on the banking efficiencies. (Driffield et al.,; 2007) examined a positive impact of higher ownership concentration on the firm value and its capital structure. When ownership concentration is low then the change of capital structure is depend upon the strict managerial approach. (Friend and Lang; 1998) found that ownership concentration play an important role in the firm performance. The strong control of owners can control and direct the managers in achieving the organization goals.

(Baysinger et al; 1985) explored that there is a positive correlation between independent directors and the accounting performance of the firm. (Hambrick et al; 2000) also agreed with these results. (Agrawal et al ;1996) found a negative correlation between independent board of directors and the performance of the firm. On the other hand, studies by (Klein; 1998), 9Bhagat et al; 1997), and (Hermalin et al; 1991) contradicted the abovementioned results and found no significant relationship between independent directors and the accounting performance of the firm. Similarly, (Jeffrey et al; 1990) determined no relationship between the outside directors and the firm performance.

Methodology

This study will explore the practices of corporate governance in major financial Institutions in Pakistan and measure its impact on their performance. Further, it will also compare the performance of conventional interest based banks and Islamic banks based on profit and loss sharing (PLS) system from the perspective of corporate governance. Pakistan has adopted an unusual three-tier Shari'a-compliance structure to ensure "deep and extensive" supervision of Shari'a compliance. The structure consists of the following components; (1) internal Shari'a advisers for Islamic banks, (2) a national Shari'a-complaince inspection unit, and (3) a national Shari'a advisory board established by the State Bank of Pakistan, the central bank (Akhtar 2006).

The secondary data of corporate governance and banking performance variables of thirty banks will be used for the analysis purpose over the period of 2001-2009. The chosen study period experienced huge structural changes in the banking sector of Pakistan. Many foreign banks are acquired by the private banks. Small banks are merged with large banks. Due to this reason, this study included only those banks which are performing their operations consistently over the period of last one decade. The selected thirty banks include all types of banks such as private, public, foreign and Islamic. But the number of private banks is more than public, foreign due the liberalization reforms of the banking sectors.

Three financial performance variables are used in this study of the selected banks i.e., return on Equity (ROE), return on Asset (ROA) and Earning per share (EPS). The data of the above mentioned variables are collected from the annual financial reports of the respective banks. The corporate governance variables such as ownership concentration (OC), board size (BS), independent Audit Committee (IAC) and tier shari's compliance structure (TSC) in case of Islamic banks is used. These variables are chosen on the basis of previous literature. The ownership concentration is defined as the majority of the shares are held by a small group of investors. For this ownership concentration value is determined by the following assumption:

$$\text{Ownership Concentration} = \text{\% of shares held by top five shareholder}$$

Board size (BS) is consisted on number of total directors in the banks. It includes both executive and non-execute members of the bank. Independent Audit Committee (IAC) is defined as the number of non-executive audit committee in the audit team of the bank. Tier Shari'a Compliance (TSC) is used as a dummy variable in this study. As it is a main component of Islamic banks and not present in conventional banks.

The data of above mentioned variables are combined in three of the following econometric models. The following models are multiple linear regression models in which financial performance variables are independent whereas corporate governance variables are dependent. The significance of these models is test with ANOVA first for whole banking sectors and then for different types of banks such as private, public, foreign and Islamic banks.

Model-I $\quad \mathrm{ROE} = \alpha_1 + \beta_1 \mathrm{BS} + \gamma_1 \mathrm{OC} + \delta_1 \mathrm{IAC} + \rho_1 \mathrm{TSC} + \epsilon$

Model-II $\quad \mathrm{ROA} = \alpha_2 + \beta_2 \mathrm{BS} + \gamma_2 \mathrm{OC} + \delta_2 \mathrm{IAC} + \rho_2 \mathrm{TSC} + \epsilon$

Model-III $\quad \mathrm{EPS} = \alpha_3 + \beta_3 \mathrm{BS} + \gamma_3 \mathrm{OC} + \delta_3 \mathrm{IAC} + \rho_3 \mathrm{TSC} + \epsilon$

Assumptions:

In the above mentioned models the coefficients of board size are β_1, β_2 and $\beta_3 > 0$, whereas γ_1, γ_2 and $\gamma_3 > 0$ are the coefficients of ownership concentration. The independent audit committee coefficients are δ_1, δ_2 and $\delta_3 > 0$. The coefficients of tier shari'a compliance are ρ_1, ρ_2 and $\rho_3 > 0$.

Result and Analysis

The impact of corporate governance practices on the performance of banking sector in Pakistan is measured in different perspectives. Firstly, overall banking sector performance and corporate governance practices are tested through three different multiple regression models over the period of 2001-2009.

The results show that all three models are highly significant at 1, 5 and 10% level of significance for all banks. The coefficients of determination of the said models are 0.28, 0.20 and 0.33 respectively. It indicates that the performance of the banking sector in Pakistan is influenced by the corporate governance practices.

Four independent variables of corporate governance are used in the abovementioned models, in which Board Size (BS) of the banks is highly significant at 1, 5 and 10% level of significance in all three models. It has a positive impact on the performance of all banks as per our assumption. Other two variables, Independent Audit Committee (IAC) and Ownership Concentration (OC) are not significant in all three models. But the coefficients of ownership concentration are affecting negatively on the performance of the banks. It is suggested that if holding of shares are concentrated in small group of investors then it hurts the accounting returns of the banks.

On the other hand, Tier Shari'a Compliance (TSC) is significant in model-I at 10% level of significant and in model-III at 5 and 10% level of significance. In both models, the impact of

TSC is negative on the banking performance. It means that the involvement of shari'a compliance in the governance structure of the banks creates hurdle in getting higher accounting returns. (see table-I)

Secondly, the impact of corporate governance is observed on the performance of different types of banks such as Private, Public and Foreign banks. The selection of banks for comparison purpose is critical at this point though only those private, public and foreign banks are selected which are consistently operating over the sample period. All those banks are ignored which merged or acquired during this period. Another comparison is made on the basis of banking operations i.e., Islamic and non-Islamic (conventional) banking practices. For this, the whole banking sector is divided into two categories, Islamic and conventional banks and then make a comparison between them i.e., which category performance is more influenced by the corporate governance variables.

The comparison results show that model-I is highly significant at 1, 5 and 10% level of significance for all types of banks except foreign banks. It is also highly significant for Islamic and Conventional banks. This shows that the return on equity for private, public, Islamic or conventional banks is influenced by the corporate governance variables.

As far as, the significance of individual corporate governance variables in model-I is concerned, the results show that the Board Size (BS) is highly significant at level 1, 5 and 10% level of significance for public, private, Islamic and conventional banks. Whereas Independent Audit Committee (IAC) is significant only for Islamic banks and Tier Shari's Compliance (TSC) is significant for private, public, Islamic and conventional banks.

The impact of board size is positive on return on equity for all types of banks except the Islamic banks. On the other hand, there is a mixed trend of the impact of IAC on return on equity for different types of banks. Such as there is a negative effect of IAC on Islamic, conventional and private banks, but a positive effect on public and foreign banks. The reason of this mixed trend is the nature of banking in different segments. The conventional and Islamic banks are affected negatively by the Independent Audit Committee because in conventional banks lack of transparency creates problem in the audit but in case of Islamic banks, a limited scope of operations can lower their returns. Whereas, there is a positive impact of TSC on the performance of Islamic banks but negative on all other banks. (see table-II)

The model-II is also highly significant at 1, 5 and 10% level of significance for conventional and public banks and significant at 5 and 10% level of significance for private banks. The impact of Board Size (BS) is positive and highly significant on conventional and private banks. Whereas, Independent Audit Committee (IAC) has negative and significant impact on conventional banks at 10% and on private banks at 5 and 10% level of significance. As most of the private banks are controlled by the private investors which hardly involve any of the non-executive audit members in the team due to their interests and it causes a lack of transparency in the operation. That is the reason when an independent audit committee member conducts the audit of a bank; he/she may become a hurdle in achieving their interest (see table-II) Model-III is significant at 1, 5, and 10% level of significance for all types of banks except the foreign banks. There is a positive and significant impact of Board Size (BS) on conventional, public and private banks whereas a negative and significant impact on Islamic banks. The Independent Audit Committee has a negative and significant impact on all types of banks except foreign banks. In case of Tier Shari'a Compliance (TSC), it has a negative and significant impact on the performance of conventional, private and public banks but a positive and significant impact on Islamic banks. (see table-II)

Conclusion:

This paper is an initial effort to determine the impact of corporate governance practices on the performance of Pakistani banking industry. The impact is observed in different perspectives. First, this study investigates the impact of different corporate governance variables on the accounting performance such as return on equity (ROE), return on assets (ROA) and earnings per share (EPS) for all banks. Secondly, the impact is measured on different segments of the banking sector on basis of their ownership such as private, public and foreign and on the basis of their banking practices such as Islamic and conventional.

The results of this study are evident that there is an impact of corporate governance practices on the financial performance i.e., return on equity, return on assets and earnings per share for all banks. The most significant corporate governance variable in this respect is board size. The board size has a positive relationship with all bank's financial performance. It indicates that the size of a board does matter to increase the accounting return of the banks. Though it has no technical and direct relationship with the returns but a larger board can take the better decisions for the banks to enhance their earnings.

The comparative analysis of different types of banks show that the financial performance of all types of banks is influenced by the corporate governance practices except the foreign banks. The performance of foreign banks is least affected by either of the corporate governance variables. The reason of not affecting foreign banks financial performance by the local corporate governance variables is the central control of these banks. These banks are governed by the central executed body which may be located in their parent country. There is less influence of the local governance structure on the performance of foreign banks because they are directed by the central executive committee of the bank.

It is also concluded that the different corporate governance variables have different impact on the financial performance of different types of banks. Such as board size and tier **sharia's** compliance have a positive and negative impact on all types of banks respectively except for Islamic banks. The positive impact of board size in conventional banks financial performance indicates that a larger board can protect the interest of stockholders in better way. On the other hand, tier **shari'a** compliance has a negative impact on conventional banks because of its operational limitations. But in case of Islamic banks, board size has a negative positive impact on their performance because Islamic banks have limited banking operations, whereas, a positive impact of tier shari'a compliance on Islamic banks clearly indicated that it best suits to Islamic environment.

As this is a first effort to determine out the impact of corporate governance variables on the accounting performance of banking sector in Pakistan, it can be further studied by increasing or replacing the different corporate governance variables and increasing the sample period of the study.

Table-I- Multiple Regression Analysis Results for All Banks in Pakistan

	R Square	Co-efficient (P-value)	SE
ROE and Corporate Governance Variables - Model-I			
Overall Model-I	0.28	0.00***	0.07
BS		0.01 (0.000***)	0.00
IAC		0.02 (.40)	0.02
OC		-.01 (0.53)	0.01
TSC		-0.04 (0.05*)	0.01
ROA and Corporate Governance Variables - Model-II			
Overall Model-II	0.2	0.00***	0.01
BS		0.01 (0.00***)	0.00
IAC		0.01 (.98)	0.02
OC		-.01 (0.11)	0.00
TSC		0.01 (0.75)	0.00

EPS and Corporate Governance Variables - Model-III

Overall Model-III	0.33	0.00***	0.05
BS		0.97 (0.00***)	0.16
IAC		-2.56 (.0.06*)	0.14
OC		-.1.29 (0.67)	0.93
TSC		-3.02 (0.03**)	0.01

Note:

*** Significant at 1, 5, 10% level of significance
**Significant at 5, 10% level of significance
*Significant at 10% level of significance

Table-II Impact of Corporate Governance on Different Types of Bank

	R Square	(P-value)	SE	BS	IAC	OC	TSC
ROE and Corporate Governance Variables - Model-I							
Islamic	0.60	0.00***	0.04	-0.03 (0.00***)	-0.06 (0.00***)	0.12 (0.23)	0.02 (0.02**)
Conventional	0.19	0.00***	0.08	0.01 (0.00***)	-0.16 (0.31)	0.014 (0.56)	-0.01 (0.04**)
Public	0.56	0.00***	0.01	0.02 (0.00***)	0.02 (0.23)	0.02 (0.43)	-0.01 (0.07*)
Private	0.22	0.00***	0.01	0.01 (0.00***)	-0.01 (0.42)	-0.022 (0.46)	-0.00 (0.03**)
Foreign	0.47	0.56	0.02	0.00 (0.33)	0.00 (0.95)	0.02 (0.65)	-0.01 (0.16)
ROA and Corporate Governance Variables - Model-II							
Islamic	0.23	0.84	0.01	0.01 (0.62)	-0.02 (0.67)	0.11 (0.13)	0.01 (0.53)
Conventional	0.21	0.00***	0.01	0.1 (0.00***)	-0.01 (0.07*)	0.00 (0.81)	0.01 (0.12)
Public	0.29	0.00***	0.01	0.12 (0.01**)	-0.02 (0.58)	0.00 (0.40)	0.00 (0.16)
Private	0.26	0.02**	0.01	0.3 (0.00***)	-0.04 (0.03**)	0.00 (0.80)	0.00 (0.18)
Foreign	0.30	0.63	0.01	0.01 (0.43)	0.00 (0.41)	0.03 (0.33)	-0.01 (0.13)
EPS and Corporate Governance Variables - Model-III							
Islamic	0.53	0.00***	0.04	-1.97 (0.00***)	-5.7 (0.00***)	0.13 (0.33)	0.02 (0.03**)
Conventional	0.29	0.00***	0.05	0.94 (0.00***)	-1.97 (0.03**)	-2.37 (0.08*)	-0.01 (0.01**)
Public	0.52	0.00***	0.06	1.08 (0.01**)	-7.72 (0.00***)	1.2 (0.41)	-0.02 (0.00***)
Private	0.28	0.00***	0.05	0.51 (0.00***)	-3.94 (0.00***)	4.62 (0.01**)	-2.23 (0.09*)
Foreign	0.45	0.33	0.03	0.01 (0.33)	0.00 (0.95)	0.02 (0.65)	-0.03 (0.15)

Note: *** Significant at 1, 5, 10% level of significance
**Significant at 5, 10% level of significance

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