

# **Nexus Between Corporate Governance and Financial Performance: An Empirical Study on the Fourth Generation Private Banks of Bangladesh**

## **Abstract**

The private banks in Bangladesh have been growing since 1982 with the adoption of privatization policy. After that, nine banks started their banking operation during 1982-1987. Following these, eight banks had entered their banking operation during 1992-1996 and thirteen banks had introduced their banking activities throughout 1998-2001. After a while, ten banks had started to commence their activities in between 2013-2016. These banks are correspondingly regarded as first generation, second generation, third generation, and fourth generation private banks. At this backdrop, this study intends to analyze the nexus between corporate governance and financial performance of fourth generation private banks of Bangladesh for the period from 2014 to 2023. Board size, board gender diversity, board independence, bank size, audit committee size, board meeting and risk management committee are used as corporate governance attributes while return on asset and return on equity are used as proxy of measuring financial performance of banks. Panel data regression analysis techniques have been conducted to scrutinize the relationship between corporate governance and financial performance of banks. The results find that board size, board independence, audit committee size, board meeting and bank size have a statistically significant relationship with financial performance of banks while board gender diversity and risk management committee size do not have any association with the bank performance. These findings will have practical implications on the banks with respect to the composition and functioning of the board of directors leading to boost the performance. Thus, the information derived from this study can be effective and helpful to enhance the understanding of the governing bodies of banks for accelerating banking performance.

**Key words:** Corporate governance, bank, financial performance, board of directors, return on equity, return on equity.

## Introduction:

Banks, being the heart of the financial structure of every economy ameliorate economic growth by mobilizing the flow of funds from surplus to deficit sectors as well as by transforming the flow of funds into productive investments. Therefore, banking sector plays an important role in the economic development of Bangladesh as well as exist at the top of the financial system with an immense importance( Dutta and Saha, 2021). So, banks, being a highly regulated sector all over the world protect funds of depositors and keep away from negative externalities arising from systemic risk (Berhe, 2022). Banks of different countries face so many problems such as lack of transparency, adverse selection and moral hazard, difficulty of bank business, high debt ratio, liquidity problem, solvency problem as well as banking scams and the major responsible factor to the occurring of these is weak corporate governance practices (Macey & O'Hara, 2003). Thus, corporate governance has become a crucial aspect for proper functioning of banks.

Corporate governance encompasses structures to direct and manage the institutions activities for boosting shareholders' value by enhancing corporate performance and accountability, taking into account the interest of other stakeholders (Jenkinson & Mayer, 1992). Corporate governance is the sum of systematic process to control, direct, and manage for ensuring fairness, transparency and accountability in the organization(Hossain, 2022). Good corporate governance is the key to have better financial performance. Corporate governance is a tool to ensure the existence of transparency, accountability and fairness in corporate reporting.

So, like other organizations, commercial banks have to follow to the management, control, and supervision rules set by the board of directors and managers ( Trung, 2022). The board of directors performs fully executing functions to maximize the benefits of shareholders as well as reduce the bank's risks leading to have the bank's performance .

Therefore, it is crucial to explore the relationship between corporate governance and bank performance as banks' performance depends on the fair practices of banking activities. Unfortunately, in Bangladesh, it has been seen that it is frequently facing different scams due to

the lack of practices of corporate governance (Rahman and Islam ,2018). Banking sector of Bangladesh has been brought under criticism due to some recent financial scam. For instance, BDT 4000 crore loan scam of Hallmark Group, BDT 200 crore loan scam of Bismillah Group where six commercial banks were involved ( Alam and Akther, 2017). Such fraudulent activities actually indicate lack of corporate governance practices in the banks.

Such incidents proved the gap in good corporate governance practices in the banks. And also Bangladesh is being pressurized by the international community's to follow an international, comparable corporate governance framework (Hossain, 2017). Hence, this shows that there is a dire need that banks should strictly implement the corporate governance rules and regulations in order to comply with the international standards. So, it can be said that good corporate governance is one of the prime factors leading to have the best financial performance. Hence, there is a critical need of study on banking performance influenced by corporate governance.

Even though a number of studies have been undertaken between corporate governance and financial performance of banks, nexus between corporate governance and financial performance of recently established private banks is very few. These banks have been facing severe competition with already established state-owned, private, and foreign counterparts. Thus, drawing any inference between corporate governance and financial performance of the newly established banks starting in 2013 namely fourth generation banks has become difficult as the existing literature provides sufficient literature on banks of different time period before 2013. At this backdrop, using the data from 2014 to 2023, this study aims at analyzing the nexus between corporate governance and financial performance of fourth generation private banks.

This research contributes to the existing literature of banking governance from a perspective of internal governance mechanisms to explain bank performance, and also to show how different corporate governance aspects are a significant determinant of bank performance. The study would also provide some practical, insights to banking institutions on how they can enhance performance in their organizations. The results of this study therefore, should benefit bank regulators, policy makers, and others.

**Objectives of the study**

The main objective of the paper is to analyze how does corporate governance affect financial performance of fourth generation banks of Bangladesh. Under this main objective, followings are the specific objectives:

1. To Identify the corporate governance attributes having influence on the financial performance of banks.
2. To determine the significant corporate governance attributes affecting the financial performance of banks.
3. To evaluate the effects of corporate governance on the financial performance of banks.

## Data and Methodology

This study is based on secondary data. Based on availability of data, 10 (ten) fourth generation private banks in Bangladesh have been considered for a time frame of 2014 to 2023. All the relevant data have been collected from the annual reports of respective banks.

### **Indicators of financial performance of banks**

Following the empirical study of Owiredu and Kwakye, 2020, Pham et al., 2021 Alam and Akther, 2017; present study uses Return on Assets (ROA) and Return on Equity (ROE) to measure bank performance.

### **Corporate Governance attributes as independent variables**

#### **Board size (BSIZE)**

Board size can be defined as the number of directors on the board responsible for solving the issues between shareholders and executives calls for the presence of the board of directors (Li et al. 2020). Agency theory asserts that a larger board of directors improves business performance. However, when board size is too large, then different co-orientation problem arises leading to the poor performance.

#### **Board gender diversity (FDIRS)**

One aspect of the diversity of the board of directors is gender diversity. Therefore, female diversity on board of directors enhances firm value as well as improve firms' profitability, including banks (Charilaos et al., 2019).

#### **Board independence (INDP)**

An independent board member as someone who does not have an ownership interest and no right in managerial affairs in the company .They can limit the level of information asymmetry, which increases the transparency of the financial reporting leading to positive relationship between independent board of directors and value of the firm .

### **Bank Size (SIZE)**

Bank size increase has a positive impact on the bank performance (Rahman and Islam, 2018). Through increasing bank size, a bank can exercise good control over efficiency and that also increase the bank performance. On the other hand, a larger bank might find it difficult to manage its excess capacity in a cost saving manner due to improper screening and monitoring to borrower.

### **Audit committee size (ASIZE)**

Audit Committee plays a significant role in the oversight of the company's risk management policies and programs . The size of audit committee has a positive effect on performance (Hossain, 2022., Mihail et. al., 2022) .

### **Board Meeting**

The success of the board depends on the frequency of its meetings, as this can improve the firm's performance by providing the board with more opportunities to monitor and analyze management's performance (Hsu & Petchsakulwong, 2010). So, boards should think about holding more meetings if the situation calls for more control and oversight .

### **Risk management committee**

It represents the total members in the risk management committee. Risk management committee is positively related to bank performance ( Hossain, 2022)

**Table 1: Summary of the research variables used in the study**

<b>Independent variables</b>	<b>Notation</b>	<b>Measurements</b>	<b>Expected sign</b>
Board size	BSIZE	The number of directors on the board	+/-
Board gender diversity	FDIRS	The proportion of female directors on the board	+
Board independence	INDP	The proportion of independent directors on the board	+
Bank Size	SIZE	Natural logarithm of total	+/-

		assets of banks	
Audit committee size	ASIZE	The number of members in the audit committee.	+
Board Meeting	BM	Total number of board meeting	+
Risk Management Committee	RMC	Total members in the risk management committee.	+
<b>Dependent variables</b>			
Return on Assets	ROA	Ratio of net income to assets	
Return on Equity	ROE	Ratio of net income to equity	

## Presentation of the models to be estimated

Following the empirical studies, panel data estimate will be used to examine the nexus between corporate governance and bank performance supported by Therefore, panel regression will be run; i.e. ROA,ROE and NPL will be regressed against corporate governance attributes.

Therefore, in my study, using three measures of bank performance, following three research models will be estimated :

### Research model 1:

$$ROA = \alpha_i + \gamma t + \delta_1 BSIZE_{ij} + \delta_2 FDIRS_{ij} + \delta_3 INDP_{ij} + \delta_4 DUAL_{ij} + \delta_5 SIZE_{ij} + \delta_6 ASIZE_{ij} + \epsilon_{ij}$$

### Research model 2:

$$ROE = \alpha_i + \gamma t + \delta_1 BSIZE_{ij} + \delta_2 FDIRS_{ij} + \delta_3 INDP_{ij} + \delta_4 DUAL_{ij} + \delta_5 SIZE_{ij} + \delta_6 ASIZE_{ij} + \epsilon_{ij}$$

ROA= Return on assets

ROE=Return on equity

BSIZE= Board size

FDIRS=Gender diversity representing female directors

INDP=Board independence

SIZE= Bank size

ASIZE= Audit committee size

BM= Board meeting

RMC= Risk Management Committee

$\alpha$  =intercept,

$\beta$  = regression coefficients,

$i$  and  $t$  = bank and time,

$\varepsilon$  = disturbance term.

## **Literature review**

It consists of two parts: first part is about the theoretical frameworks explaining the interactions between corporate governance and financial performance, second part focuses on the empirical studies of the connection between corporate governance and financial performance of banks.

### **Agency theory**

This theory states that managers may increase the size of a firm to receive larger compensation or to enjoy private benefits from the prestige of running a large firm (Gabaix & Landier, 2008).

Therefore, it predicts a negative relationship between firm's size and performance. In another context, Agency theory suggests that a higher proportion of independent directors should lead to better firm performance since it reduces the conflict of interests between the shareholders and managers and makes management more effective through better monitoring.

### **Stewardship Theory**

In the stewardship, managers are assumed to be good agents of the corporations and diligently work to achieve high levels of corporate profit and shareholders returns (Donaldson and Davis 1994). Stewardship theorists, reject agency assumptions, suggesting that directors frequently have interests that are consistent with those of shareholders

### **Empirical studies**

Board composition and board gender diversity have positive and significant impacts on bank performance as well as board size has significantly negative effects on bank performance of Ethiopia during 2011-2019 (Berhe (2023). Similarly, board size and board independence are significantly affirmatively related with bank performance in Bangladesh ( Hossain, 2022).) There is also significant positive relationship between board size and financial performance in Ghana (Owiredu and Kwakye ,2020 ). Board independence and board size have a significant positive impact on performance while female directors appear to have no impact on performance of banks in Bangladesh (Muttakin and ullah , 2012).

In another argument, board size influences bank performance negatively whereas independent board has a positive impact on bank performance of Serbia (Babic et. al.,2020). In another

explanation, board size, board independence and board gender diversity have been found to have significant and negative effects on the performance of banks while board gender diversity in South Asia including Pakistan, Sri Lanka, India and Bangladesh for a period of 2011-2022. (Mehmood et al.,2023).

Board independence is the most important factor in determining bank performance of 34 countries of G20 with a total 331 banks for a period of 2001-2019 (Johennesse and Budidarma (2022) similar to the study of Mehmood et al., 2023. Similarly, board independence has positive effects on financial performance of banks in the Middle Eastern and North African (MENA) region during the COVID-19 pandemic period (El-Chaarani et.al.,2022). In contrast, percentage of independent directors has a significant negative relationship on the performance ((Bezawada,2020).

Audit committee is found to have a favorable influence on the financial performance of the companies listed on the Bucharest Stock Exchange (BSE) in Romania using more than 70 firms are collected by hand, for the 2016–2020 period (Mihail et. al.,2022). Very few studies have included the audit committee as corporate governance attribute. Furthermore, the number of meetings have a positive significance on 34 bank performance in India from 2009-2018 (Bezawada,2020).

### **Development of Hypotheses**

From the literature cited above, following hypotheses can be developed:

H1: BSIZE affects positively/negatively the bank performance.

H2: FDIRS has a positive impact on the bank performance.

H3: There is a positive relation between INDP and bank performance.

H4: ASIZE impacts positivity the bank performance.

H5: BM has a positive relation with bank performance.

H6: RMC affects positively the bank performance.

H7: SIZE affects positively /negatively the bank performance.

### **Findings and analysis**

## Descriptive statistics

Both the dependent and explanatory variables are represented by condensed descriptive statistics in Table 2. By examining the panel dataset of 10 fourth generation banks that operate in the banking industry from 2014 to 2023, consisting of 91 observations. The key elements of it are the mean, maximum, and minimum values, as well as standard deviation values. The maximum and minimum values indicate that the data is not normal under study. Also, the maximum value of BM refers to the presence of outliers, and increased dispersion therefore suggests the presence of heterogeneity among the banks under study.

**Table 2: Descriptive statistics of all variables used in the study**

Variables	Observation	Mean	Standard dev.	Min	Max
ROA	91	.0092	.0009	-.0205	.0381
ROE	91	.0845	.0060	-.073	.217
BSIZE	91	15.4505	.4123	6	20
FDIRS	91	2.4505	.1837	0	5
INDP	91	1.4725	.1338	0	4
ASIZE	91	3.4065	.0883	1	5
BM	91	10.9120	.4863	4	24
RMC	91	3.3406	.0873	1	5
SIZE	91	4.7295	.0365	3.8744	5.4703

## Regression analysis

This study contains an unbalanced panel data set. For choosing the appropriate model for the study, I conduct The Hausman test to determine if a fixed or random effect regression model is appropriate for the research where the random effect is in the null hypothesis, and the fixed effect is in the alternative hypothesis. It is found that null hypothesis is rejected in all the research models evidenced by Hausman test as the p-value is less than .05. Thus, It indicates that the random effect regression model is an excellent choice for our estimation.

## Research model 1

**Table 2: Output of random effect model**

Factors	Coefficients	Std. Error	t-value	Pr(> t )
Intercept	-0.039325892	0.017037647	-2.30818	0.023478*
BSIZE	0.000378331	0.000280055	1.350915	0.180394*

FDIRS	0.000425909	0.000590916	0.720762	0.473081
INDP	0.00333575	0.000888525	-3.75426	0.000321*
ASIZE	0.000403607	0.001315119	0.306898	0.75969*
BM	3.3064E-06	0.000223534	0.014792	0.988234
RMC	-0.000808641	0.001452419	-0.55676	0.579193
SIZE	0.010123528	0.003595976	2.815238	0.006086*
$R^2=48.54$ Adjusted $R^2=42.67$ p-value =.0143 Observations=91				

### Analysis:

Random effect model demonstrated in table 2 exhibits that BSIZE, INDP, ASIZE and SIZE can strongly impact the financial performance of fourth generation private banks of Bangladesh while performance is measured by ROA. Positive coefficients of BSIZE and INDP implies that Independent directors and board size results at increasing financial performance with proper implementation of corporate governance practices. And also ASIZE and SIZE boosts bank performance positively. Each of these factors is statistically significant at the 5% significance level with respective p value less than .05. The overall model is strongly statistically significant with . A variation in financial performance of banks can be explained by the model at 42.67%. These findings supports the results of Hossain, 2022 and Mihail et al., 2022 and Rahman & Islam, 2018.

On the other hand, FDIRS, BM, and RMC are found to have statistically insignificant relation with financial performance of banks. Therefore, it is concluded that the statistically significant factors affecting the financial performance of fourth generation private banks of Bangladesh are BSIZE, INDP, ASIZE and SIZE.

Research model 2

**Table 3: Output of random effect model**

Factors	Coefficients	Std. Error	t-value	Pr(> t )
Intercept	-0.542554803	0.099425	-5.45691	1.91e-07*
BSIZE	-0.003299634	0.001634	2.018993	0.046716
FDIRS	-0.003192239	0.003448	-0.92573	0.357272

INDP	0.011596989	0.005185	-2.2366	0.027995*
ASIZE	-0.004346456	0.007675	-0.56635	0.0057266*
BM	-0.001244538	0.001304	-0.95407	0.0342821*
RMC	-0.00036578	0.008476	-0.04316	0.965681
SIZE	0.133344295	0.020985	6.354342	1.07E-08*
$R^2 = 36.54$ Adjusted $R^2 = 31.09$ p-value = 2.2179E-06 Observations = 91				

Only significant corporate governance attributes such as INDP, ASIZE, BM and SIZE at 5% significance level which can enhance the financial performance of banks. The positive coefficient of INDP means the more the directors are independent, the greater will be the implementation of corporate governance practices leading to achieve the better financial performance. Negative coefficients of ASIZE and BM implies that the greater the size of the audit committee and the number of meeting held in banks, the lower will be the bank performance. These findings have confirmed the empirical results.

### Panel regression diagnostic: Multicollinearity test

**Table 4: Pair-wise Correlation matrix**

	<i>B</i> SIZE	<i>F</i> DIRS	<i>I</i> NDP	<i>A</i> SIZE	<i>B</i> M	<i>R</i> M	<i>S</i> IZE
<i>B</i> SIZE	1						
<i>F</i> DIRS	0.289308	1					
<i>I</i> NDP	-0.02738	-0.00682	1				
<i>A</i> SIZE	0.295981	0.152869	0.18085	1			
<i>B</i> M	0.048466	-0.22734	0.252837	-0.00496	1		
<i>R</i> MC	0.424026	0.213339	0.06637	0.560117	0.263731	1	
<i>S</i> IZE	-0.24228	0.178268	0.587761	0.125089	0.256482	0.10852	1

To check that the independent variables do not influence each other, the correlation between the independent variables is tested. Correlation matrix shows the correlation between variables used in the study. Based on Gujarati (2021), which indicates that the multi-collinearity occurs when the correlation between two variables is more than 80%. In this study, the independent variables are correlated with each other at a relatively low level. More specifically, the highest correlation obtained between INDP and SIZE is .5877. As the correlation coefficient is less than .80, It is

therefore confirmed that there is absence of multicollinearity in our regression analyses. As a result, the output of fixed effects model shows an unbiased estimator of financial performance of banks.

### Variance inflation factor

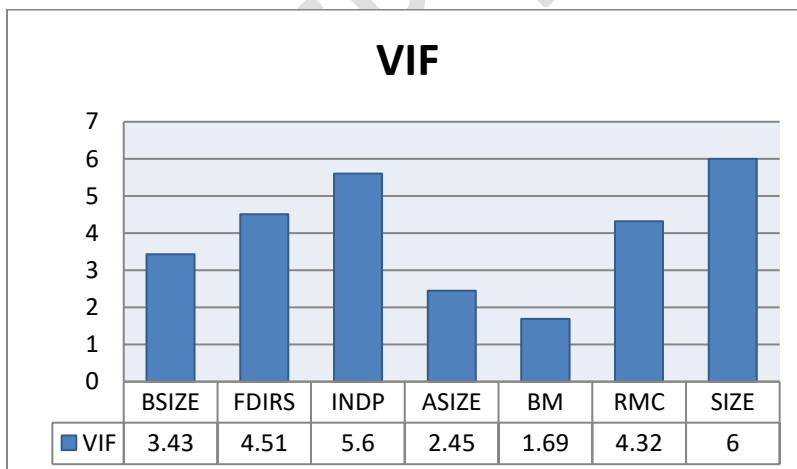
VIF is commonly used to estimate multicollinearity. This measures how much the variance of an estimated regression coefficient increases when independent variables are correlated.

A rule of thumb for interpreting the VIF is as follows:

- 1 = not correlated.
- Between 1 and 5 = moderately correlated.
- Greater than 5 = highly correlated.

Figure 1 shows the VIFs calculated for all of the independent variables. For each variable except INDP and SIZE, the VIF is less than 5, indicating that they are moderately correlated. But the VIF is really considered to be problematic when its value is greater than 10 (Shrestha, 2020). So, the VIF values of INDP and SIZE are not that much a concerning issue. Therefore, it can be assumed that the results of the regressions are reliable and the significant variables can be considered as predictors of financial performance of the fourth generation banks in Bangladesh.

Figure 1: VIF values of explanatory variables used in the study



## Conclusion and recommendations

This study has examined the nexus between Corporate Governance and financial performance of fourth generation banks of Bangladesh. To fulfill the objectives of the study, panel regression have been run on three research models. The regression results reveal that BSIZE, INDP, ASIZE, BM and SIZE have statistically significant relation with bank performance. The positive associated between INDP and bank performance indicates that the more the directors are independent, the higher will be the financial performance through closely monitored management, reduced agency conflicts between owners and managers, improved internal control, proper utilized bank resources. Positive coefficient of SIZE shows that increasing bank size would increase financial performance through effective better monitoring. Negative association between ASIZE and bank performance reflects that smaller size of audit committee can ensure transparency while implementing better corporate governance leading to promote bank performance. BM impacts negatively the bank performance as sometimes; too many meeting can unnecessarily waste time and divert the concerned people from core tasks leading to poor performance. Thus, the corporate governance attributes such as BSIZE, INDP, ASIZE, BM and SIZE promote financial performance of banks. Therefore, banks should focus the portion of independent director(s), in their board of directors' composition, concentrate on the small size of board, small number of meeting and large asset-base of banks in order to boost financial performance. The findings of the study will act as the guidelines for the bank management to implement proper corporate governance practices with a view to accelerating bank performance as comprehensive corporate governance is crucial aspect for the survival and well-functioning of the banks.

There were some limitations in this study. The sample for the study is very small as it only includes fourth generation banks of Bangladesh. The use of larger sample may generate different findings. And there may be some other external factors having an influence on the bank performance apart from corporate governance mechanism. Further studies can be conducted

including those as control variable to investigate the relation between corporate governance and Bank performance.

#### **COMPETING INTERESTS DISCLAIMER:**

Authors have declared that they have no known competing financial interests OR non-financial interests OR personal relationships that could have appeared to influence the work reported in this paper.

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