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| Title      | Corporate Governance and Firm Performance in the Financial Sector                 |
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| Citation   | 東南アジア研究年報, 52, pp.107-115; 2011   |
| Issue Date | 2011-03   |
| URL        | <a href="http://hdl.handle.net/10069/25150">http://hdl.handle.net/10069/25150</a> |
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This document is downloaded at: 2020-10-26T04:53:10Z

# Corporate Governance and Firm Performance in the Financial Sector

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## Abstract:

This study aimed at investigating the relationship between corporate governance and performance of the firms by particularly concentrating on the financial sector of Bangladesh. We have constructed corporate governance index (CGI) for 64 financial institutions listed in Dhaka Stock Exchange (DSE) and related it to the performance of the firms. As a proxy for the measure of performance we had used return on assets (ROA) of the firms. The finding of the study revealed that, corporate governance index (CGI) is quite poor in the financial sector of Bangladesh. Also governance has positive but insignificant relationship with firm performance (return on assets).

**Keywords:** Corporate governance, firm performance, financial sector, Bangladesh

## 1 . Introduction

Corporate governance is the procedure by which public corporations are governed and monitored by the stakeholders: shareholders, auditors, regulators, credit agencies, and so forth (Kim and Nofsinger, 2007). It is most often viewed as both the structure and the relationships which determine corporate direction and performance. The relationship between good governance and firm performance is widely argued by researchers. Research

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studies conducted previously by different researchers on corporate governance in the financial sector and its effect on the bank performance has found this impact to be positive ( Joh . 2003; Anderson and Campbell . 2003; Verghese , 2002; Akhavein et al . 1997 , Hughes et al . 1999 ). The concept of corporate governance is a new concept to the corporate arena of Bangladesh. In the face of corporate failure around the world especially of Enron, World Com etc. debacles, it has demanded much attention of both regulatory bodies and the investors. The enactment of Sarbanes Oxley Act in 2002 elicits the importance of good governance in a corporate entity. In Bangladesh, aftermath, Securities and Exchange Commission ( SEC ) came across with the code of corporate governance in 2006 which comprises certain provision to be followed by all stock exchange listed corporate bodies including financial institutions ( SEC , 2006 ). Almost four years have passed since the enactment of this notification. Accordingly, it would be interesting to examine whether practicing good governance is paying the financial firms in terms of positive financial performance or not. Thus, the objective of the study is to examine the relation between good governance and profitability of the listed companies in Bangladesh by particularly concentrating on the financial sector. The more specific objective of this study is to measure the corporate governance compliance status of the financial firms.

## **2 . Literature Review**

The seminal paper by Shleifer and Vishny ( 1997 ) mentions that corporate governance deals with ways in which suppliers of finance assure themselves of getting a return on their investment. After parting with their money, the financiers have little or no control over how management chooses to spend the funds. The need for corporate governance in their view thus arises from the existence of the agency problem. As outlined by Coase ( 1937 ) , Jensen and Meckling ( 1976 ) and Fama and Jensen ( 1983 ) in previous studies, separation of management and finance creates the problem of different objectives for the principal and agent. The appointed agent works toward maximizing the agent's own personal return instead of the investors' objective of maximization of shareholder wealth. They draw examples of widespread expropriation of financial resources by managers in the absence of corporate governance around the world to illustrate the phenomena. According to Shleifer and Vishny, good corporate governance is achieved through strong enforcement of legal rights of the shareholders, concentration of ownership among a few large investors and distribution of debt obligations over a large creditor base. Shleifer and Vishny acknowledge the potential drawbacks these prescriptions may have. However, they note the success in achieving good

corporate governance through the advocated policy solutions around the world. They throw up an interesting question regarding why executive compensation has not been more widely used in alleviating agency cost and thus promote good corporate governance.

In the developed world, two dominant corporate governance systems have emerged as referred to by Henderson and Cool ( 2003 ). They illustrate that on the one hand there is the market-based system which follows the practices in the United States and the United Kingdom and the other is the bank-based system which follows the practices in Japan and Germany. In the market based system, firms raise capital from a liquid external capital market and managers in these firms are controlled by the shifting of investments by equity market participants. Concentration of ownership is scarce in these systems. Nonetheless, a liquid market presents opportunities for takeovers and corporate raiding. On the other hand, in a bank-based system, ownership is concentrated around a large bank which has a long term relationship with the firm. As such, the bank exerts heavy influence over the firms' management and this leads to good corporate governance. Their study finds certain the market based system to be superior in certain selected areas of corporate governance.

This Anglo American model of corporate governance is detailed by Reed ( 2002 ). The four pillars of this system are a board exclusively elected by shareholders, dependence on financial markets for financing, low reliance on banks and highly limited interaction with government agencies. Reed mentions that developing countries are adopting the Anglo American model due to several reasons namely, failure or limited success of other systems and influence of the world bank and IMF which dictate conditions that promote the Anglo American model while managing debt crises in these economies.

In an effort to empirically measure this concept of corporate governance, Gompers, Ishii and Metrick ( 2003 ) use data from publications of Investor Research Responsibility Center ( IRRC ) in USA. The data contains 24 corporate-governance provisions of 1500 firms for the period ranging from September 1990 to December 1999 . By adding points for provisions ( represented by laws and bylaws ) that reduce shareholder rights, they construct a " Governance Index ". Those that are high on the index are the ones with low corporate governance( which they call dictatorship portfolios )and vice versa( democracy portfolios ). In order to test for performance, they estimate Carhart's ( 1997 ) four factor model where monthly excess return is a function of value weighted market risk premium, as well as the monthly returns on portfolios that reflect impacts of size, book-to-market and momentum. Using this model as a basis, performance-attribution time-series regressions leads them to find that democracy portfolios outperform dictatorship portfolios by as much as 8.5 percent for the ten years. Moreover, they find that weak shareholder rights are associated with low-

er sales growth than other firms in the industry. Another important finding here using Tobin's Q is that firm value was negatively correlated with the index, i.e., higher a firm's index, lower its value. The paper offers a balanced perspective by hypothesizing several explanations for the findings noting that they cannot establish causality. They present partial evidence for possible higher agency costs due to weak shareholder rights. Another alternate explanation for poor returns for the firms was correlation with characteristics of the markets in the 90s which resulted in abnormal returns for some. The authors assert a strong relationship between corporate governance and firm performance and underline the importance of further research by controlling for other variables.

Furthering the discussion by Gompers et al. ( 2003 ) and Bebchuk et al. ( 2009 ) postulate that not all the 24 provisions in the IRRC database are relevant to firm value. In particular, they state six provisions to be of use. These are staggered boards, limits to shareholder amendments of the bylaws, supermajority requirements for mergers, supermajority requirements for charter amendments, poison pills and golden parachutes arrangements. They narrow the GIM index down to these six components calling it the " Entrenchment Index " and expand the time set from 1990 to 2003 . Their findings are similar to that of GIM. They emphasize the need to focus the index rather than broadening it as they illustrate they have done so by eliminating noise being caused by the 18 other provisions that are part of the IRRC database. They also speculate that existence of two provisions: poison pills and golden parachutes are reflective of managers who already acknowledge the firm's lower value. Therein lies the problem of corporate governance and performance being endogenous. Subsequent studies have tried to address this issue.

Taking the cue from previous research, Bhagat and Bolton ( 2007 ) , find that the indices discussed earlier as well as stock ownership by board members and CEO-chairman separation are positively correlated with operating performance as opposed to overall performance. For this purpose, operating performance is measured by them as operating income before depreciation divided by total assets. To overcome the well documented problem of endogeneity, instrumental variables ( after being put through the Hausman test ) representing performance, governance, ownership and capital structure are used. The use of ROA in this study is significant as internal measures of performance possibly better reflect the effects of governance rather than stock prices which impound investor expectations and raise questions of violating market efficiency. The authors conclude by suggesting a single governance measure: actual ownership of board members to construct the index since in the study they find stock ownership of board members to be positively related to both future operating performance and to the probability of change in management in firms with low

market value.

The studies conducted to examine the relationship between corporate governance and firm performance has found this relationship to be positive. Before the economic crisis in Korea, evidence on corporate governance and firm profitability from Korea was put forward by Joh (2003). This study reported that weak corporate governance system offered few difficulties against controlling shareholders expropriation of minority shareholders. In fact, weak corporate governance systems enabled the poorly managed firms to stay in business that lead to inefficient allocation of resources regardless of low profitability over the years. Corporate governance activity at Japanese banks revealed that during the pre-crisis (1985-90) period, there was no relationship between bank performance and non-routine turnover of bank presidents (Anderson and Campbell 2003). However, in the post-crisis (1991-96) period a significant relationship was observed between bank performance and non-routine turnover. Verghese (2002) restated the role and the need of good corporate governance in India in his several forums. From the 1980s and early 1990s, profit efficiency studies of U.S. bank merger and acquisitions (M&A) uncovered that M&As improved profit efficiency, and that improvement can be connected to portfolio shifts that produced higher revenues due to improved risk-expected return limits (e.g., Akhavein et al., 1997, Hughes et al., 1999). However in Bangladesh there is not only a dearth of studies investigating the linkage between corporate governance and performance, but an absence of empirical research that investigates the status of corporate governance of firms (Iqbal, 1997; Raihan 2003; BEI, 2003 and 2004; Ahmed and Yusuf, 2005). This study is a modest attempt to fill this vacuum.

### 3 . Methodology and Data

The corporate governance index data was constructed by using structured survey instruments. The questionnaire included corporate governance indicators such as, meeting with stakeholders, board meeting, board size and composition, board structure, and audit committee (see **Table 1**). As a procedure for filling, knowledge base method was used by considering annual reports of the year 2008, web sites, regulatory notifications and reports. We had taken one year time lag and took return on asset (ROA) for 2009 as a proxy to measure the performance of the firms. Disproportionate stratified random sampling method was used on a population of 100 listed service industries in Dhaka Stock Exchange and selected 64 firms companies (64%). This included banks, insurance companies, leasing and finance companies. As a methodology t-test was applied to test the difference between positive and

negative corporate governance compliant firms in terms of profitability performance.

Table 1: Contents of the corporate governance index

| CG Indicators              | Minimum Score | Maximum Score |
|----------------------------|---------------|---------------|
| Meeting with Stakeholders  | -5            | +5            |
| Board meeting              | -5            | +5            |
| Board Size and Composition | -5            | +5            |
| Board Structure            | -5            | +5            |
| Audit Committee            | -5            | +5            |
| TOTAL SCORE                | -25           | +25           |

## 4 . Findings

### 4.1 Corporate Governance Index (CGI)

Corporate Governance Index (CGI) had a maximum value of 25 and minimum value of minus 25 . Out of this the highest value scored by a firm was found to be plus 21 . On the other hand, the lowest score was found to be minus 21 . The average CGI for all the firms was approximately 4 . Among the individual corporate governance indicators the highest average score was in board meeting ( 2.15 out of 5 ) . Whereas, the lowest was in audit committee ( -0.96 ) . Scores in other three indicators were , 0.91 , 0.28 , and 1.68 in meeting with stakeholders, board size and composition, and board structure, respectively.

### 4.2 Corporate Governance Index and Return on Assets

Corporate Governance Index (CGI) and return on assets (ROA) for the sample financial sector firms are plotted in Figure 1 . Some of the firms are omitted for having extreme

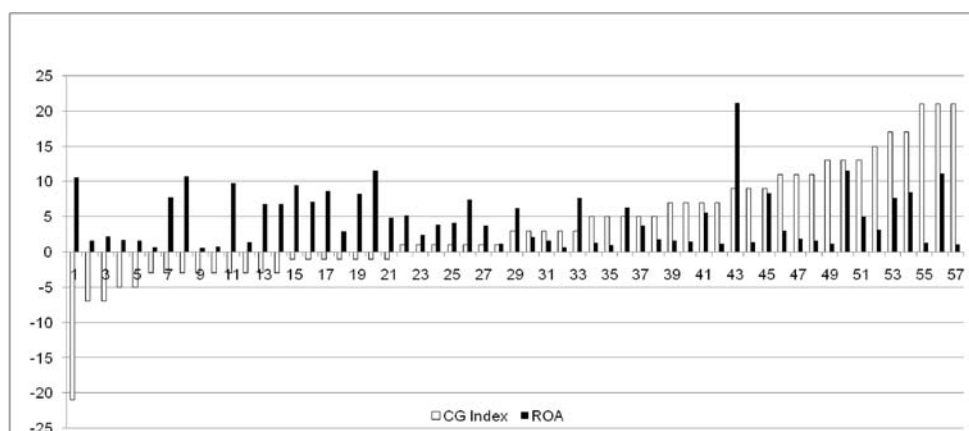


Fig.1 Corporate Governance Index (CGI) and ROA for the firms

values of ROA. From the figure we can see that, overall it is difficult to find any relation between CGI and ROA. Some of the firms having negative CGI are showing reasonably positive ROA. However, majority of the firms showing positive CGI are also showing positive ROA.

#### 4.3 Test of difference in sample mean

Table 2: Corporate Governance and Profitability ( ROA)

|   | NCGI | PCGI   |
|---|------|--------|
| Sample Size(valid N )                       | 20   | 40     |
| Mean  | 5.55 | 9.72   |
| S.D.  | 3.88 | 20.04  |
| <i>t</i> -test of paired samples:           |      |        |
| Difference in sample means                  |      | 4.17   |
| <i>t</i> -test statistic                    |      | -0.918 |
| Decision: Do not reject the null hypothesis |      |        |

The *t*-tests results are summarized through Tables 2 , which shows the results of the difference of return on assets ( ROA ) between negative corporate governance index ( NCGI ) and positive corporate governance index ( PCGI ) companies. From the table we can see that, ROAs of the PCGI firms are higher than that of the NCGI firms ( 4.17) . Thus we can comment that firms practicing good governance are performing better in terms of profitability. However, our two-tailed *t*-test does not support this observation. It should be noted here that equal variances were assumed on all statistical tests. This leads us to accept the null hypothesis.

## 5 . Discussion

The proposition that good governance leads to better firm performance is widely argued by research studies. This study is a modest attempt to test this hypothesis by taking the case of the financial sector in Bangladesh. The results of the study can be summarized as follows:

From the findings we have study we have found that, average corporate governance index ( CGI ) is very poor for the sample financial sector firms in Bangladesh. However, most of these firms had reported a very high level of corporate governance compliance status in the notification report submitted by them to the Securities and Exchange Commission ( SEC ) and published in the annual reports. Thus it can be commented that, corporate governance



status of the financial firms are not as good as reported to SEC.

With regard to the relationship between corporate governance and firm performance we have found positive but statistically insignificant relationship. It can be said that the impact of higher emphasis by SEC to practice good governance is improving the overall governance status in the financial sector in Bangladesh. However it would take time to be reflected on the profitability performance.

From national to company level, policies measures should be initiated that can contribute towards a positive relationship between corporate governance and firm performance - a " virtuous " nexus. Policy guidelines such as enhancing the capacity of the financial sector for developing the knowledge, skill and expertise to understand and disseminate the concept and importance of corporate governance and its role in increasing performance are needed to improve the governance status and reflect it on profitability performance.

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