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ASSESSMENT OF CORPORATE GOVERNANCE PRACTICES & ITS IMPACT ON FINANCIAL PERFORMANCE: A CASE OF BANKING SECTOR OF PAKISTAN

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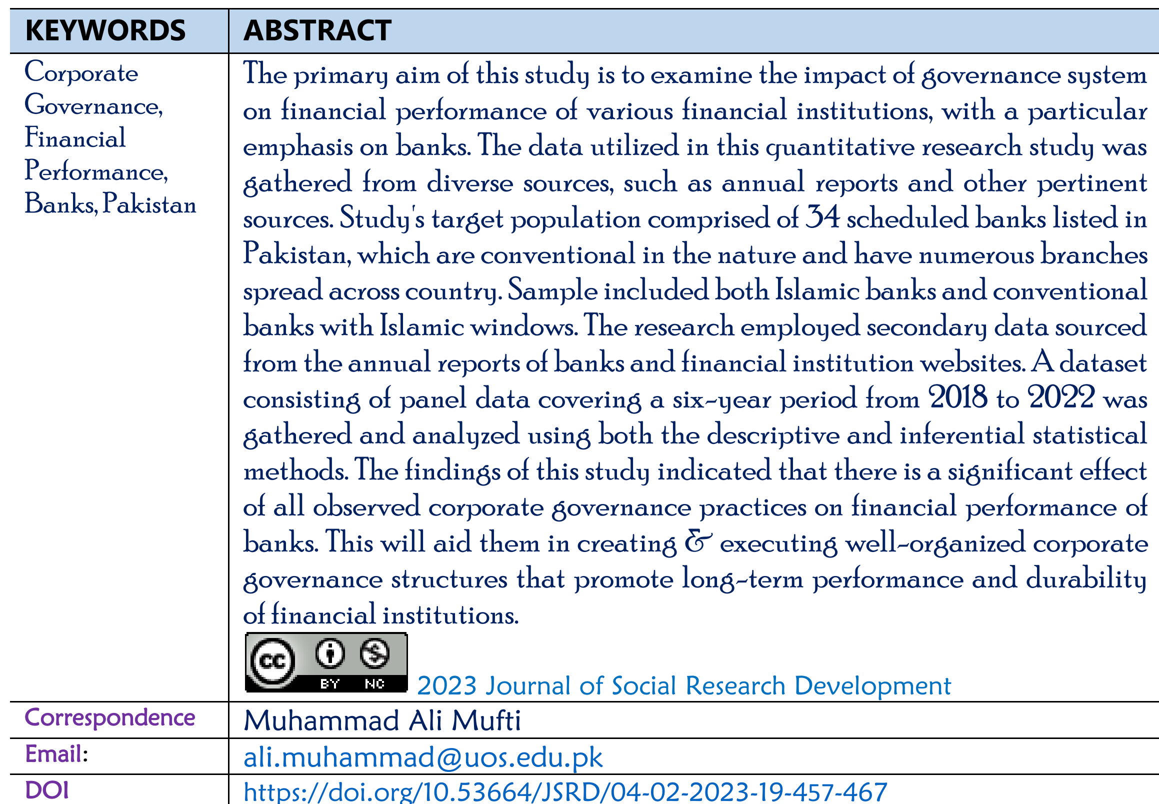

KEYWORDS

Corporate Governance, Financial Performance, Banks, Pakistan

ABSTRACT

The primary aim of this study is to examine the impact of governance system on financial performance of various financial institutions, with a particular emphasis on banks. The data utilized in this quantitative research study was gathered from diverse sources, such as annual reports and other pertinent sources. Study's target population comprised of 34 scheduled banks listed in Pakistan, which are conventional in the nature and have numerous branches spread across country. Sample included both Islamic banks and conventional banks with Islamic windows. The research employed secondary data sourced from the annual reports of banks and financial institution websites. A dataset consisting of panel data covering a six-year period from 2018 to 2022 was gathered and analyzed using both the descriptive and inferential statistical methods. The findings of this study indicated that there is a significant effect of all observed corporate governance practices on financial performance of banks. This will aid them in creating & executing well-organized corporate governance structures that promote long-term performance and durability of financial institutions.

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INTRODUCTION

Over the last twenty years, there has been a notable increase in the focus on corporate governance within both Islamic and non-Islamic financial institutions, as noted Christofi, Christofi and Sisaye (2012). The researchers from diverse fields still regard it as the highly pertinent subject (Demirag & Khadaroo, 2011). Research, such as the study conducted by Rashid, Zobair, Chowdhury and Islam (2020), has demonstrated that corporate governance is widely recognized as fundamental principle

that is essential for ensuring institutional efficiency. The corporate governance is often linked with conventional financial systems that existed prior to the inception of the Islamic Financial System. However, its importance is applicable to all forms of the organizations (Dawood, Rehman, Majeed & Idress, 2023). The implementation of corporate governance practices is crucial for improving institutional performance by mitigating agency problems within the organization. The governance framework comprises the collection of guidelines and protocols that direct the functioning of the organization and its engagements with stakeholders (Lin & Qamruzzaman, 2023). Aside increasing acknowledgement of the significance of corporate governance in financial institutions, there are still various domains that necessitate additional scrutiny. It is imperative to examine precise effects of various governance mechanisms on financial performance of organizations (Almashhadani & Almashhadani, 2023).

The governance structure relies on the essential components such as board size, risk management committees, and audit committees. Still, the extent of their individual contributions to performance outcomes remains unclear. It is imperative to possess a thorough comprehension of interconnections between governance mechanisms and financial performance so as to develop effective governance frameworks (Amosh, Khatib & Ananzeh, 2023). Secondly, it is vital to assess the efficacy of current corporate governance protocols in speaking agency issues within financial institutions. Occurrence of agency problems can be attributed to division of ownership and control, leading to conflicting interests between management and shareholders (Kabir & Chowdhury, 2023). In light of aforesaid context, the current research endeavors to examine the impact of corporate governance on the financial performance of financial institutions. The study places particular emphasis on board size, risk management committees, and audit committees. This study aims to offer the valuable insights to the policymakers, regulators, and financial institution managers by examining the connections between governance mechanisms and financial performance indicators. The results of this study will facilitate the establishment and execution of proficient corporate governance structures that enhance performance, safeguard shareholders' entitlements, and guarantee the general stability of financial organizations.

LITERATURE REVIEW

Corporate Governance

Corporate governance, also referred to as CG, aims to establish a harmonious equilibrium between the management objectives of the company's upper and lower echelons. Its primary objective is to enhance the efficiency of activities directly associated with company's operations, such as financial management and operational endeavors. When effectively implemented, CG serves as mechanism to promote sustainable economic growth (Javid & Iqbal, 2010). It can be employed as tool to assess the proficiency of management in making decisions and the functioning of the Board of Directors (BODs). The identification of governance mechanisms that can effectively address agency problems has the potential to improve overall performance and stability of financial institutions. As stated in Javid and Iqbal's (2010) thesis, CG delineates ownership of business resources and defines essential regulations governing distribution of investment returns, including dividends, among common and

preferred stockholders, employees, managers, and key stakeholders. In essence, it serves as structure that governs business ownership.

Board Size

The individuals primarily responsible for ensuring effective management of a firm's operations are the members comprising the board of directors. These directors play a crucial role within company as agents, carrying out the authority granted to them through the firm's articles of association and memorandum of association. Khan, Khan and Tahir (2017) assert that the board of directors assumes a vital role in the resource reliance, as they are tasked with ensuring the organization's long-term sustainability. Moreover, they hold accountability for the fiscal well-being of the organization and serve as the conduit for providing guidance, advice, as well as disciplinary actions (Wasiuzzaman & Gunasegavan, 2013). Thus, considering the significant role of the board of directors in promoting good corporate governance, they often occupy a prominent position in various procedures (Khan & Zahid, 2020).

Board Composition

As per the findings of Carter, Simkins and Simpson (2003), the constitution of the board of directors has become a crucial matter for corporate management in present scenario. It is widely recognized among industry experts that the performance of an organization is significantly impacted by the composition of its board, which should include both independent and non-executive directors. The aforementioned phenomenon can be attributed to board's function of managing agency problem through consistent oversight of the management, as per Al-Matari (2013). Thus, according to Bebeji, Mohammed and Tanko (2015), board of directors is commonly considered as principal intellectual asset of the organization. In this connection, prior research has investigated the ratio of external independent directors and non-executive directors serving on the board. The present study centers on this particular facet.

Audit Committee

The board of directors plays a vital role in governance processes of any company, where ownership and administration are separate entities. Their primary objective is to protect shareholder interests. To fulfill this objective, the board establishes an audit committee, which assumes responsibility for tasks related to financial reporting, internal control, & risk management. This committee comprises the individuals with the authority and resources to oversee these aspects and ensure their proper functioning (DeZoort, Hermanson, Archambeault & Reed 2002). Nevertheless, according to Al-Matari, Al-Swidi and Fadzil (2014), the audit committee's association with the companies' financial performance (ROA) is not significantly positive. The audit committee is integral part of company's governance system and effects its performance based on factors such as committee's size, meeting frequency, and the members' expertise in financial matters (Chan & Li, 2008; Dakhlallh, Rashid, Abdullah & Shehab, 2020).

Risk Management Committee

Risk can be defined as anything that has the potential to hinder the achievement of one's goals. It can either be beneficial, aiding in the acquisition of assets, or detrimental, reducing the expectation

of higher returns. Regardless, it can have a positive or negative impact. Risk holds significant status in any organization, but it is particularly crucial in the banking industry. This is primarily due to the reliance of the market on funds provided by individuals with surplus money. Unlike other human endeavors, the banking sector is highly vulnerable to risk. Crouhy et al. (2006) have classified this particular risk into several categories. Certain researchers have identified credit risk, market risk (also known as systematic risk), operational risk as primary categories of risk that banks encounter. Risk management is an essential aspect of financial institutions. Risk management concerns in the context of corporate governance in the banking sector have a substantial influence not only on the financial performance of the industry but also on broader economic development. As per findings of Badriyah et al. (2015), inclusion of strong monitoring mechanism is imperative for risk management system to be deemed effective.

RESEARCH METHODOLOGY

In order to attain the stated goal, study procured information pertaining to financial performance indicators and governance criteria from diverse origins, predominantly annual reports. The research conducted in this study is of a quantitative nature. Participants in this research are employees from different types of financial organizations, with specific focus on banking institutions. The population of interest for this study consists of established traditional banks in Pakistan. Currently, there are 34 scheduled banks operating in country, with over 14,000 branches nationwide. Among these banks, 29 are domestic banks, while remaining five are international banks. Probability sampling, exactly simple random sampling, was employed to select suitable sample of 20 banks for this research study. The sample includes both conventional banks and Islamic banks, as well as conventional banks with Islamic windows.

In terms of data collection, research utilized various sources, including annual reports of financial organizations, publications, and websites. Due to nature of the study, secondary data was utilized. Panel data from annual reports and websites of listed banks were collected for six-year period from 2018 to 2022. Descriptive statistics and inferential statistics were employed to analyze obtained data. Descriptive statistics were used to summarize and characterize data, while inferential statistics were used to draw conclusions from observations. Research employed a correlation test, inferential statistical method, to determine degree of relationship between variables. Additionally, multiple regression model was utilized to forecast the influence of predictors on the dependent variables in this research study.

Table 1 Variables Operationalization

Independent Variables	Definition	Data Collection Sources
Board-Size	No. of Directors on Board	Annual Report/Website
Board-Composition	No. of Independent Non-Executive Directors in Board	Annual Report/Website
Risk-Management Committee	Non-Executive Directors in RMC	Annual Report/Website
Audit Committee	Indep: Directors in Committee	Annual Report/Website
CEO Duality	When COE holds both positions as COE/ Chairman	Annual Report/Website

RESULTS OF STUDY

Tables 2 Correlation Analysis

	ROA	ROE	BS	BC	RMC	AC	DC
ROA	1						
ROE	.429	1					
BS	-.1925	-.247	1				
BC	-.2053	-.2423	.016	1			
RMC	.1479	-.0552	.4432	.032	1		
AC	-.3166	-.2668	-.0523	.1026	-.4284	1	
DC	.4015	.3184	-.2374	-.1482	-.2032	.0622	1

The correlation coefficient, which varies between -1 and 1, serves as a measure of the magnitude and direction of association between two variables. A positive correlation coefficient indicates a direct association between two variables, implying that a rise in one variable is typically accompanied by an increase in another variable. In contrast, a correlation coefficient that is negative denotes an inverse association, whereby an increase in one variable is typically accompanied by a decrease in another variable. The financial performance metrics of ROA and ROE exhibit a moderate positive relationship, as indicated by their positive correlation coefficient of 0.429. in this connection, the return on Assets (ROA) exhibits a weak negative correlation with the Board Size (BS) (-0.1925) and Board Composition (BC) (-0.2053), suggesting that a negative association between board-related factors and the ROA.

The analysis indicates that there exists a marginal connection between risk management committee (RMC) and financial performance metrics. Specifically, RMC exhibits a weak positive correlation of 0.1479 with return on assets (ROA) and a weak negative correlation of -0.0552 with return on equity (ROE). The results indicate that there exists a weak negative correlation between the audit committee and financial performance, as evidenced by negative correlation coefficients of -0.3166 and -0.2668 with respect to ROA and ROE, respectively. Data indicates that there exists moderate positive correlation between director's committee and financial performance metrics, specifically ROA (0.4015) and ROE (0.3184).

Tables 3 Regression Analysis ROA as Outcome

OLS			REM			FEM		
Variable	Coeff.	t-Stat	Variable	Coeff.	z-Stat	Variable	Coeff.	t-Stat
BS	04937	1.14**	BS	-.0583	1.04**	BS	.0278	-0.67**
BC	-.00856	-1.46	BC	.00203	0.35	BC	.00722	1.22
RMC	-.0006	-2.06**	RMC	-.0007	-2.17**	RMC	-.0073	-2.21**
AC	-.02139	-2.57***	AC	-.0186	-1.98**	AC	-.01828	-1.80**
DC	.004512	4.46***	DC	.00218	2.09**	DC	.001241	1.15**
CONS	-023069	-2.19**	_CONS	-.0117	-1.10*	_CONS	-.00792	-0,72*
F-Stat	9.41		Wald (5)	18.35		F-Stat	12.98	
R2	0.3335		R2within	0.1323		R2within	0.1492	
Adj R2	0.2981		between	0.3844		between	0.1203	
			overall	0.2492		overall	0.1331	

The OLS model indicates that the Board Size (BS) variable exhibits a coefficient of 0.04937 and an t-Stat of 1.14**, which implies a positive but weak correlation with ROA. Coefficients of BS exhibit negativity in both Random Effects Model (REM) and Fixed Effects Model (FEM), however, they do not demonstrate statistical significance. The Board Committee (BC) has reported that the Ordinary Least Squares (OLS) model has yielded coefficient of -0.00856 and an t-Stat of -1.46. These results suggest a negative correlation amid variables, albeit a weak one, with regards to Return on Assets (ROA). Nevertheless, coefficient lacks statistical significance in both Random Effects Model (REM) and Fixed Effects Model (FEM). According to findings of Risk Management Committee (RMC), OLS model indicates a coefficient of -0.0006 and an t-Stat of -2.06**, indicating a negative correlation with ROA, albeit a weak one.

Both the REM and FEM models exhibit adverse coefficients for RMC, with comparable statistical significance. The Audit Committee (AC) has reported that the OLS model has yielded a coefficient of -0.02139 and an t-Stat of -2.57***, suggesting a moderate negative correlation with ROA. The regression models of REM and FEM exhibit adverse coefficients for alternating current (AC), with differing degrees of statistical significance. As per the findings of OLS model, Director's Committee (DC) has reported a coefficient of 0.004512 and an t-Stat of 4.46***, which signifies a robust positive correlation with ROA. The regression models for the REM and FEM exhibit statistically significant positive coefficients for DC.

Table 4 ROE as an Outcome variable

OLS			REM			FEM		
Variable	Coeff.	t-Stat	Variable	Coeff.	z-Stat	Variable	Coeff.	t-Stat
BS	8.2107	0.51**	BS	8.2107	0.53**	BS	15.418	0.68**
BC	-4.7941	-1.04	BC	-4.7941	-1.09	BC	-8.1315	-1.40
RMC	.616151	2.52***	RMC	.616151	2.72***	RMC	.955496	2.94***
AC	-24.857	-3.79***	AC	-24.85	-3.98***	AC	-43.564	-4.39***
DC	.85055	1.07*	DC	.85055	1.91*	DC	.799800	0.76**
CONS	-5.7452	-0.69	CONS	-5.7452	-0.83	CONS	-3.0157	-0.28
F-Stat	12.98		Wald-x2	40.41		F-Stat	17.96	
R2	0.3006		R2within	0.3158		R2within	0.3188	
Adjs.R2	0.2635		between	0.9165		between	0.9067	
			Overall	0.3006		Overall	0.2987	

The OLS model indicates that the Board Size (BS) variable has a coefficient of 8.2107 and an t-Stat of 0.51**, which implies a positive but weak association with ROE. The coefficients of BS in both the Random Effects Model (REM) as well as Fixed Effects Model (FEM) exhibit positivity, though with marginally elevated t-Stat values, thereby signifying feeble positive associations with Return on Equity (ROE). According to the OLS model, coefficient for the Board Committee (BC) is -4.7941 with an t-Stat of -1.04. This suggests that there exists a weak negative correlation between Board Committee and ROE. The coefficients of BC in both REM and FEM models exhibit negativity, while the t-Stat values demonstrate an increase, thereby indicating the feeble negative association with ROE. The Risk Management Committee (RMC) has reported that the OLS model has yielded the coefficient of 0.616151 and an t-Stat of 2.52***. In this connection, this indicates the presence of the

moderate positive correlation with ROE. The regression models of REM and FEM exhibit favorable coefficients for RMC, accompanied by elevated t-Statistics, indicating the moderate and positive correlation with ROE.

The Audit Committee (AC) has reported that OLS model has revealed robust negative correlation with ROE, as evidenced by a coefficient of -24.857 and an t-Stat of -3.79***. The regression models of REM & FEM exhibit adverse coefficients for AC, accompanied by elevated t-Statistics, indicating robust negative associations with ROE. As per the findings of OLS model, the Director's Committee (DC) has reported a coefficient of 0.85055 and an t-Stat of 1.07*. These results suggest a positive but weak correlation with ROE. DC coefficients in both REM and FEM models exhibit positive values, albeit with fluctuating t-Stat values, which suggest a tenuous positive correlation with the return on equity (ROE). This suggests that there exists a weak negative correlation between the Board Committee and ROE. In this connection, this indicates presence of moderate positive correlation with ROE. The constant term, denoted as (_CONS), signifies point at which the regression equation intersects the y-axis. All models exhibit negative coefficients, indicating a negative baseline effect on return on equity (ROE). In this linking, the level of statistical significance exhibits variation among the models.

The F-Statistic is utilized to assess the global significance of the regression model, which determines if the collective independent variables have a substantial influence on the dependent variable, namely the Return on Equity (ROE). The R-squared (R2) metric denotes the fraction of variability observed in the return on equity (ROE) that can be accounted for by the explanatory variables. The Adjusted R-squared, denoted as Adj R2, is a statistical measure that accounts for the influence of the number of independent variables on the R2 value. To summarize, the results of the regression analysis indicate that there exists a positive but weak correlation between Board Size and ROE. The Board Committee exhibits weak negative correlation, whereas Risk Management Committee and Director's Committee display weak positive correlations. A robust inverse correlation is observed between Audit Committee and the Return on Equity (ROE). It is imperative to acknowledge that the aforementioned findings are contingent upon particular model employed. Thus, it is advisable to conduct additional scrutiny to evaluate the resilience and causal connections of these variables with respect to ROE.

DISCUSSION

The research aims to investigate the impact of corporate governance on the financial performance of traditional banking institutions using various proxies. The first proxy examined is board size (BS), which has a significant positive effect on the performance of traditional banks, as indicated by measures such as return on assets (ROA) and return on equity (ROE). This finding is consistent with previous research, emphasizing importance of boards of directors in corporate governance. Besides, smaller board sizes are associated with cost-cutting benefits and improved communication, leading to greater efficiency. However, Guest (2009) suggests the negative association between board size and profitability, indicating a complex relationship. In this connection, another proxy used in the study is the board composition, particularly the percentage of the independent and non-executive

directors. Thus, the research findings suggest no significant relationship between these factors and organizational success.

This aligns with the contentious nature of the literature on corporate governance, where economic value conferred by presence of outside independent directors remains a debated topic (Mutamimah & Saputri, 2023). While some studies indicate the impact of board composition upon the financial performance, others argue against its significance. Cost of risk management is identified as another important factor influencing the performance of traditional banks. The study finds that a successful risk management system requires effective supervision, typically facilitated by a risk management committee composed of directors with the necessary skills. The findings support previous research that highlights the role of risk management committees in mitigating risks and safeguarding the financial well-being of organization. Still, Elamer and Benyazid (2018) suggest negative association between risk management committee effectiveness and financial performance, contradicting the current study's findings.

The presence of CEO duality, where the CEO also serves as the chairman of the board, is found to have a significant and positive influence on the firm performance. This suggests that CEO duality contributes to a more efficient governance system, which positively affects organizational outcomes. These findings contradict prior research that indicates no substantial relationship between CEO duality and financial success (Eriqat et al., 2023). The debate surrounding the impact of CEO duality on performance remains inconclusive. Overall, the research highlights the importance of corporate governance in the financial performance of traditional banking institutions, with board size, board composition, risk management, and CEO duality being key factors of interest. The findings contribute to the existing body of knowledge on corporate governance and its implications for organizational outcomes.

CONCLUSION

The aim of this study was to examine the influence of the governance structure on the financial performance of the banks operating in Pakistan. The data collected from annual reports and other relevant sources provided a comprehensive understanding of the relationship between financial institution performance and corporate governance measures. The study's sample consisted of 20 banking institutions, including both the Islamic banks and conventional banks that provide Islamic windows. The selection process was carried out using the method of simple random sampling. The findings of the study suggest that the corporate governance measures, such as the board size, risk management committee, audit committee, and the director's committee, significantly impact the performance of financial institutions. The results suggest that incorporating effective governance practices has the positive effect on the financial institutions' performance. Through the analysis of panel data over a period of six years, robust findings were obtained regarding persistent association between governance and performance. The results of this study are of significant importance to individuals who hold authoritative positions, such as the policymakers, regulators, and financial institution managers.

The findings emphasize the importance of implementing and strengthening corporate governance frameworks to boost long-term performance and resilience of the financial institutions. By realizing

established governance measures, stakeholders are enabled to make informed decisions with the goal of improving governance systems within their organizations. This study provides an academic contribution to existing body of knowledge regarding correlation between corporate governance and financial institution performance, with particular emphasis on banking industry in Pakistan. The study at hand has distinct emphasis on banks that operate exclusively within the geographical confines of Pakistan. Hence, it is crucial to carry out further research to broaden the scope of the results to encompass other financial institutions and countries. Additional research could explore the causal relationships between various governance mechanisms and financial performance, while also analyzing potential moderating or mediating factors that may affect this correlation. In brief, this study provides valuable insights into the impact of corporate governance on the performance of financial institutions. This can provide the fundamental basis for the future research and the policy development in this field.

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