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Corporate Governance and Efficiency in Nepalese Commercial Banks

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The 1997-1998 economic crises in the Asian countries highlighted the importance of corporate governance. In developing countries such as Nepal, a good governance of banks is crucial for the survival of its economy. This study investigates the impact of corporate governance on efficiency of Nepalese commercial banks and covers 29 commercial banks out of 31 banks from the 2005-2011 time spans. Corporate governance variables are represented by board size, independence and diligence, Audit Committee size, independence and diligence and ownership structure. The non-performing loan variable is used for bank's efficiency. The regression analysis is used to examine the relationship between corporate governance and efficiency of bank. The findings show that bigger board and audit committee size and lower frequency of board meeting and lower proportion of institutional ownership lead to better efficiency in the commercial banks.

Keywords: Corporate governance, commercial bank, board, audit committee, ownership structure, efficiency, Nepal.

1. Introduction

The banking sector plays a crucial financial intermediary role in any economy. The 1997-1998 economic crises in the Asian countries highlighted the importance of corporate governance. The corporate governance of banks is more important than other industries (Adnan et al., 2011). Poor corporate governance of the banks can drive the market to lose confidence in the ability of a bank then it leads to economic crisis in a country and invite systemic risk (García-Marco & Robles-Fernández, 2008). In contrast, good corporate governance strengthens property rights; minimize transaction cost and the cost of capital, and leads to capital market development (Claessens & Fan, 2002). Corporate governance reforms are of great significance for developing countries like Nepal, to gain a sustained effort to attract Foreign Direct Investment and Foreign Portfolio Management, and to mobilize greater saving through capital market (Maskay, 2004). Specifically, the central bank of Nepal reported severe lapses in corporate governance in every bank. Despite issuing directives to strengthen corporate governance in 2005, the results were not improved. So the objectives of this research are to fill a gap as the first in-depth study in the role of corporate governance in efficiency of Nepalese commercial banks. Interestingly the findings of the research are consistent with the previous studies conducted in various countries.

The paper is organized as follows: the next section reviews the literature. Section three presents the methodology. Results are described in section four and section five summarizes the discussion and conclusion.

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2. Theoretical Framework and Hypothesis Development

The main theoretical assumption of this research relies on the agency framework. The discussions about corporate governance and ownership structure are made from the perspective of agency framework. They are as:

2.1 Board Size and Efficiency

The agency theory assumes that smaller board is recommended to minimize the agency cost, by effective control over the management whereas larger boards might increase a large number of potential interactions and conflicts among the group members (Yoshikawa & Phan, 2003). Conversely, there is an another school of thought in favor of larger board which believes that firms with larger board size have the ability to push the managers to track lower costs of debt because creditors view these firms as having more effective monitors of their financial accounting process and increase performance (Anderson et al., 2004). Jensen & Ruback (1983) argue that the size of the board should be limited to seven or eight members. Based on the Codes of Corporate Governance in Nepal, the board of directors consists of five to nine members. Some studies have suggested smaller boards are better for improving firm performance (Lipton & Lorsch, 1992; Barnhart & Rosenstein, 1998) while some other studies provide positive relationship between board size and firm performance (Zahra & Pearce, 1989; Mak & Li, 2001). However, Ghabayen (2012) found no any relationship between board size and a firm’s performance.

2.2 Board Independence and Efficiency

Board independence is very important to efficiently monitor the managers and minimize the agency cost because independent director on board have better controlling and monitoring for the opportunistic activities of the management. Several researchers have suggested that higher proportion of independent non-executive directors reduce the agency problems (Choe & Lee, 2003) and effective board consists of greater proportion of outside directors (Zahra & Pearce, 1989). Although the executive directors have specialized skills, expertise and valuable knowledge of the firms’ operating policies and day-to-day activities, there is a need for the independent directors in the board to add the fresh ideas, independence, objectivity and expertise gained from their own fields (Choe & Lee, 2003). Considering the importance of independent director on board, Nepalese bank should appoint one independent director from the professional bodies prescribed by central bank of Nepal. Some researchers Baysinger & Butler (1985) and Ezzamel & Watson (1993) found outside directors are positively related with a firm’s performance whereas Wen et al. (2002) and Brick & Chidambaran (2008) observed the negative result between outside directors and a firm’s performance. In different direction, Kajola (2008) found no any significant relationship between board composition and firm performance in the Nigerian listed firms.

2.3 Board Diligence and Efficiency

Board diligence as an important determinant of the board's effectiveness (Vafeas, 1999) is related to factors that include the number of board meetings and its members’ qualification. One view is that board meeting are beneficial to shareholders. A more diligent board concerned with devoting more time for supervision of manager’s activity to achieve the shareholders’ expectations. Moreover, when boards hold regular

meetings, they are more likely to remain informed and knowledgeable about relevant performance of the company leading them to take or influence and direct the appropriate action to address the issue (Abbott et al., 2003). Based on code of corporate governance in Nepal, board have to sit at least twelve times per year. Vafeas (1999) found negative relationships between board diligence and a firm's performance whereas a study conducted by Ponnu & Karthigeyan (2010) in the Malaysian firms concluded no significant relationship between frequency of board meeting and a firm's performance.

2.4 Audit Committee Size and Efficiency

Agency theory suggests that shareholders require protection because management (agents) may not always act in the interest of the corporation's owners (principals). The main role of audit committee is to improve the quality of the financial reporting (Pincus et al, 1989) which leads to improve the firm performance. Cadbury Commission suggested that the audit committee should have consisted of three members. It is likely that larger audit committee have better resources than smaller audit committee (De Zoort et al., 2002). The decision making literature has argued that increasing the number of people involved in an activity substantially increase group performance and decrease the chance for wrongdoing because collusion becomes more difficult (Burton et al., 1977). There is mixed result regarding audit committee size and a firm's performance. A study conducted by Klein (2002) and Coleman-Kyereboah (2007) revealed postive relationship between audit committee size and a firm's performance. However, other researhers Hardwick et al. (2003) and Kajola (2008) reported no relation between audit committee's size and performance.

2.5 Audit Committee Independence and Efficiency

Most people would agree, and prior research has suggested, that the independence of the audit committee is positively related to effective corporate governance oversight. Independent audit committee from management should be able to prevent management to manipulate the financial results (Beasley, 1996). The independent audit committee monitors managers better because they have no economic or personal relationship with management (Abbott et al., 2004). The empirical result on the relationship between audit committee independence and a firm's performance is ambiguous. Erickson et al. (2005) suggests the independent directors can reduce agency problem like independent audit committee. They recorded a positive relationship between audit committee independence and a firm's performance. In contrast, Klein (2002) and Weiss (2005) did not find a positive relationship between audit committee independence and a firm's performance. Coleman-Kyereboah (2007) examined 103 listed firms drawn from Ghana, South Africa, Nigeria and Kenya presented no significant associations between the independence of the audit committee and with a firm's performance. Similarly, Kajola (2008) conducted study in Nigerian firms that shows that audit committee occupied by majority of outside members has no influence on a firm's performance.

2.6 Audit Committee Diligence and Efficiency

Menon & Williams (1994) argue that meeting frequency is a signal of diligence, and therefore, audit meeting frequency can be used as a proxy for diligence. Thus, for the audit committee effectiveness, member of audit committee must be willing to invest a substantial amount of time and energy in the functioning of the audit committee (Kalbers & Fogarty, 1993). Prior research by Abbott, et al. (2003) suggests that an audit

committee that meets frequently can improve the financial accounting processes and lead to better performance. Another argument by Rebeiz & Salameh (2006) is that the quality of meetings is also important and the increasing the number of meetings doesn't necessarily enhance a firm's performance. Empirical evidence by Huang et al. (2008) found no relationship between audit diligence and a firm's performance.

2.7 Foreign Ownership and Efficiency

Relevant literature on corporate governance provides much attention to the issue of shareholder identity (Shleifer & Vishny, 1997). There are numbers of research into the relationship between ownership and bank profitability. It is accepted that foreign ownership plays crucial role in a firm's performance, particularly in developing and transitional economies (Görg & Greenaway, 2004). Most of these studies carried out in Industrial (De Young & Nolle, 1996; Genay et al., 2000) and developing countries (Bonin et al., 2005). Clarke et al. (1999) have argued that foreign banks are more profitable than domestic once in developing countries and less profitable in industrial countries.

2.8 Institutional Ownership and Efficiency

The traditional view that the ownership structure of firm has no influence on the value of the firm has been challenged by Berle & Means (1991). Accordingly, higher percentage of institutional ownership could contribute to lower the risk of the firms because stock ownership should be a better incentive mechanism when a firm's risk is high (Sanders, 1999). In addition, Bhojraj & Sengupta (2003) observed that a firms' risk, institutional ownership enjoys lower bond yields and higher bond rating due to monitoring power of the institutional owners. Pound (1988) shows that institutional investors can work out the operation of firm at a lower cost because they have more experience. Chaganti & Damanpour (1991) and Han & Suk (1998) noted postive link between institutional ownership and a firm's performance but, in contrast, Craswell et al. (1997) found negative relationship.

Based on above theoretical framework, this paper has developed following hypothesis.

Hypothesis 1: Board size is negatively related to bank efficiency.
Hypothesis 2: Board independence is positively related to bank efficiency.
Hypothesis 3: Board diligence is positively related to bank efficiency.
Hypothesis 4: Audit committee's size is positively related to bank efficiency
Hypothesis 5: Audit committee's independence is positively related to bank efficiency.
Hypothesis 6: Audit committee's diligence is positively related to bank efficiency.
Hypothesis 7: Foreign ownership is positively related to bank efficiency.
Hypothesis 8: Institutional ownership is positively related to bank efficiency

3. Methodology

This paper consists of 29 commercial banks out of 31 operational over the period of 2005 to 2011. Due to unavailability of data, two government banks have been excluded from the study. The data is collected from the annual reports of the individual bank. The efficiency of bank is the dependent variable and other eight are independent corporate governance variables in the study. The bank's efficiency also influenced by the macroeconomic condition and bank's internals specific factors. So, this paper has also

considered the macro-economic and bank specific variables to examine the relationship between corporate governance and banks' efficiency. Considering this, finally, this study includes four control variables i.e. loan growth and capital adequacy ratio as bank specific variables and gross domestic product growth rate and broad money supply as macroeconomic variables.

Descriptive and multiple regressions are the methods of analysis in the study. The complete model is as:

Efficiency = $\beta_0 + \beta_1 BS + \beta_2 BI + \beta_3 BD + \beta_4 ACS + \beta_5 ACI + \beta_6 ACD + \beta_7 FRG_OWR + \beta_8 INST_OWR + \beta_9 LG + \beta_{10} CAR + \beta_{11} GDP + \beta_{12} M2 + e_{it}$

Where,

Efficiency (NPL)	Ratio of non-performing loan to total loan at the end of each year
BS	The number of director on the board at the end of each year
BI	The ratio of independent director to board size at the end of each year
BD	The number of board meeting held during the financial year
ACS	The number of member in audit committee at the end of each year
ACI	The ratio of independent director to audit committee's size at the end of each year
ACD	The number of audit committee meeting held during the financial year
FRG_OWR	10% or more ownership held by foreign investor to total ownership at the end of each year
INST_OWR	Ratio of ownership owned by financial institute, corporate institute and other institute to total ownership at the end of each year
LG	Loan Growth
CAR	Capital adequacy ratio
GDP	Annual Gross Domestic Product growth rate
M2	Broad Money supply growth rate

4. Findings

4.1 Descriptive Statistics

The result shows that the mean value of board size is 7 with 12.5% independence and 20 times diligences. The board sized shows existence of reasonable board size as recommendation of Jensen & Ruback (1983) that a board size not more than 7 or 8 is considered reasonable in ensuring effectiveness. Similarly the mean value of audit committee size is 3.4 with 16.4% independence and Audit committee diligence proxy by meeting is 8.5. The mean value of foreign ownership (11.62%) is smaller than Institutional ownership (20.7%), which shows institution has significant ownership in bank. The mean value of NPL is 3.9%. According to a firm's specific characteristics, the sample banks have the means value for LG and CAR is 30% and 13.4% respectively. Finally the average GDP and M2 is 4.4% and 19%, respectively.

Table 1: Descriptive Statistics of Dependent and Independent Variables

Variables	Observation	Mean	Std. Dev.	Minimum	Maximum
NPL	150	3.9%	7.1%	0%	39.7%
BS	150	7	1.2	4	9
BI	150	12.5%	5.9%	0%	25%
BD	150	20		0	87
ACS	150	3.4	1.1	0	6
ACI	150	16.4%	15.5%	0%	50%
ACD	150	8.5	4.9	0	24
FRG_OWR	150	11.62%	21%	0%	75%
INST_OWR	150	20.7%	24.2%	0%	80%
LG	150	30%	50.7%	-13%	489.2%
CAR	150	13.4%	7.9%	-15.1%	69.5%
GDP	150	4.4%	0.8%	9.5%	6.1%
M2	150	19%	10.9%	9.5%	38.8%

4.2 Correlation Analysis

Table 2 presents correlation between the dependent and independent variables. The result show that board size, board independence, audit committee meeting and foreign ownership have negative correlated with non-performing loan however they are not statistically significant. It is found that audit committee size has significantly positively correlated with non-performing loan. Significant negative correlation found between board size and board independence. These results indicate that the Nepalese commercial banks have only one independent director. So the increase in board size minimizes the board independence. The result also indicates that increase in board size also positively correlated with audit committee size. In case of audit committee, no any significant relation has been found between audit committee size and independence however result shows that there is positive correlation as increase in audit committee size improves the audit committee diligence. Correlation matrices of ownership structure indicate that with the increase in institutional ownership minimize the foreign ownership vice versa.

According to Tabachnick and Fidell (2007) a multicollinearity problem exists if the correlation between independence variable exceed 0.9. The correlation shown in table indicates that the highest correlation was between GDP and M2 at 0.687.

Table 2: Correlation matrices of Dependent and Independent Variables

Variables	NPL	BS	BI	BD	ACS	ACI	ACD	FRG_ OWR	INST_ OWR	LG	CAR	GDP	M2
NPL	1												
BS	-0.055	1											
BI	-0.125	-0.270**	1										
BD	0.032	-0.130	-0.053	1									
ACS	-0.207**	0.219**	0.241**	0.02	1								
ACI	-0.093	-0.167*	0.505**	0.022	0.042	1							
ACD	-0.100	0.320**	0.103	0.090	0.246**	0.039	1						
FRG_OWR	-0.062	-0.177**	0.100	-0.174*	0.209*	0.005	-0.238**	1					
INST_OWR	0.208**	0.220**	-0.013	-0.094	0.129	-0.004	0.110	-0.137	1				
LG	-0.235**	-0.035	0.042	-0.165*	-0.005	-0.117	0.106	-0.137	-0.012	1			
CAR	-0.337**	-0.092	-0.039	0.395**	0.087	0.065	0.070	-0.211*	-0.227**	0.005	1		
GDP	-0.130	-0.011	0.228**	0.112	0.154	0.051	0.019	-0.053	-0.062	0.095	0.124	1	
M2	-0.038	-0.122	0.227**	0.060	0.065	0.012	-0.054	-0.030	-0.028	0.167*	0.056	0.687**	1

4.3 Regression Results

Table 2 shows the regression result for the ratio of NPL and corporate governance variables in the context of Nepal where commercial banks lack effective execution of the issued polices from the central bank. The higher NPL ratio, lower will be bank's efficiency. With regard to corporate governance variable, board size, audit committee (size and independence) has a significant negative related with NPL ratio, which conclude that bigger board and audit committee size and audit committee independence has better influence to bank's efficiency. As for the board diligence and institutional ownership, they have a significant positive relationship with NPL ratio, which means lower frequency of board meeting, and proportion of institutional ownership has better influence on bank efficiency. Finally, CAR has significant negative relationship with NPL ratio, which means adequate capital can be better for bank's efficiency. Rest other corporate; banks specific and macro variable have no significant relationship with bank efficiency.

Table 3: Regression Results

Independent Variable	Coefficient	t statistics	p value
BS	-0.204	-2.639	0.009
BI	0.065	0.772	0.442
BD	0.180	2.480	0.014
AC'sS	-0.379	-5.188	0.000
AC'sI	-0.286	-3.917	0.000
AC'sD	-0.086	-1.219	0.225
FORG_OWR	0.052	0.728	0.468
INST_OWR	0.155	2.319	0.022
LG	-0.128	-1.941	0.054
CAR	-0.372	-4.938	0.000
GDP	-0.073	-0.846	0.399
M2	0.033	0.393	0.695
R square	0.472		
Adjusted R square	0.426		
F Statistics	10.218		
Observation	150		

5. Discussion and Conclusions

The result between corporate governance variables and (BS, BI, BD, AC'sS, AC'sI, AC'sD, FORG_OWR, INST_OWR) and bank efficiency variable (NPL) are shown in table 3. The first hypothesis states that there is a negative relationship between board size and bank efficiency. The negative significant coefficient shows that board size has positive related with bank efficiency means larger the board decrease the NPL which improve the efficiency of banks. Thus first hypothesis there is negative relationship between board size and efficiency is not accepted. The result shows that there is no any significant relationship between board independence and bank's efficiency. Thus second hypothesis is not accepted. The result is consistent with the findings of Kajola (2008) who found no any significant association between board composition and firm performance in Nigeria. The positive coefficient of board diligence reflects that there is negative significant relationship between board diligence and bank efficiency which is consistent with the findings of Vafeas (1999). Thus, third hypothesis is not accepted.

The negative coefficient to audit committee size and independence indicates positive relationship of audit committee size and independence with bank efficiency. Thus fourth and fifth hypothesis is accepted. The result is consistent with, the findings of Coleman-Kyereboah (2007) who found positive relationship between audit committee size and firm performance similarly, with the findings of Erickson et al. (2005) who found positive relationship between audit committee independence and firm performance. The negative coefficient of audit committee diligence indicates that there is positive relationship between audit committee diligence and bank efficiency however the result is not significant which is not supporting to six hypotheses. The result supports the argument of Rebeiz & Salameh (2006) who argue that the quality of meeting is also important rather than increasing number of meeting.

The result shows foreign and institutional ownership surprisingly has different influence on bank. It is found that foreign ownership has no any significant related with bank efficiency whereas institutional ownership has negatively related with bank efficiency. Thus, seventh and eighth hypotheses are not supported. The result is consistent with

the finding of Coleman-Kyereboah (2007) who found negative relationship between institutional ownership and firm performance.

This study has been conducted under the Nepalese environment, which may affect the adoption of practicing good corporate governance. Haniffa and Hudaib (2006) reveal that the principle of corporate governance in developing countries are derived from the recommendation in developed countries, and if principles are appropriate in developed countries, it is not essential to be appropriate elsewhere in terms of differences in culture and business environment.

The objectives of this paper to examines the impact of corporate governance mechanism i.e. board size and independence, audit committee size and diligence and ownership structure in the performance of banking industry in Nepal. The study contributes to the existing literature from different perspective. Various studies have been done in context of developed economies however study regarding corporate governance and bank efficiency is very rare in context of developing countries. So, this paper is trying to bridge the gaps in the research of relationship between corporate governance mechanism and bank performance in Nepal. Moreover, the study cover 29 commercial banks operated in Nepal out of 31 commercial banks. The study covers covered more recent period, the year 2005-2011, when most of the regulatory decisions were taken by the central bank of Nepal for the corporate governance. The findings of this study have important implication for bank in Nepal since it is found that strong board size and audit committee size and higher proportion of independent director in audit committee, lower frequency of board meeting and lower ratio of institutional ownership has better influence in Nepalese banks. The result about audit committee diligence and efficiency suggests that effectiveness of audit committee meeting may be hampered with overloaded agenda, which recommend the importance of quality meeting for the efficiency of firm.

The limitation of this study is that it relies only on financial accounting report. Financial account reports suffer from the following errors: are subject to manipulation may systematically undervalue assets; produces alterations due to the nature of depreciation method implemented, method of inventory valuation, and treatment of certain revenue and expenditure items (Adusei, 2011). Next, the study considers data of only seven years. The result may differ if multiple years are considered for analysis. Based on the study, other corporate governance mechanism not studied in this research has a very significant contribution of 57.4 percent to banks' efficiency. Therefore, regarding future line of research, effort should be put at increasing the sample size, year size and the corporate governance variables, particularly in case of board: board expertise, board tenure, CEO Duality. Similarly in case of ownership structure: ownership concentration, ownership mix. I hope that, these limitations do not compromise on the validity of conclusion drawn based on the result.

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