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Performance of financial institutions: A linkages between corporate governance and performance

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ABSTRACT

This research is done to check the impact of corporate governance on profitability of banks and how different component of CG effect the equity in an organization. This study employs the data, publicly available, of 10 banks and then ratio analysis, regression and Pearson correlation test are done to test the data. Research found that corporate governance practices have a positive relationship with ROE, ROA, firm's changes in equity and then it also has a direct positive effect on the EPS. Time was less to do the research; this research can also be done on the non-financial sector to check the results and econometrical results can be checked to have a better understanding of the results. This type of research has not been done in Pakistan and this research will prove to be beneficial for the policy makers.

I. Introduction

This article will tell how corporate governance affects an institutions financial performance. We will be examining corporate governance because it deals with agency problem in a firm with ownership issues. Agency problem means that when conflict of interest arises between two parties (Jensen, 1976). We will analyze how corporate governance plays a role in Pakistan's financial institutions. Many financial institutions make profit by charging high rates on loan so they operate their business in a risker manner and have more chances of default than nonfinancial firms (Morgan, 2002). Because Financial institutions have more closeness to economy of a country, any ups and downs greatly affect the sector. So here corporate governance plays a key role. It can eliminate any risk with good performance. (Alexander, 2006). We all know that failure of HBL in USA was because of corporate failures as they were not able to manage their risk. Nowadays corporate governance is being measured in Financial Institutions in almost all countries in the world. In this study we will analyze the effect of corporate governance in Pakistan's Financial Institutions. Financial institutions have been working on how to manage risk in case of financial distress and what are the reasons behind the distress so that HBL fiasco doesn't happen again. In this study our main priority will be to calculate effects of corporate governance in firm's performance and to do this we will take corporate governance index 22. It will help us to analyze level of corporate governance in Bank (Attiya Y. Javid, 2010). I have chosen Banks as my sample because of the following reasons, In Pakistan there were more cases of bad governance in banks than in non-financial firms. Daily operations of banks are rather unique in nature. There are more stakeholders that are involved with bank performance than in non-financial firms. (Zagorchev, 2015)

Following objective for doing this research,

- To check the impact of corporate governance on profitability of banks.
- To check the impact of corporate governance on liquidity of banks.
- To analyze different components of corporate governance.
- To check impact of corporate governance on value of equity

II. Literature review

To support my hypothesis, I have gathered some literature but some of them are rejecting my hypothesis. In this literature review we will also understand the significance of Corporate governance in firm's overall performance. Here we will analyze different literature or past work that has been done on related topic. It will be helpful support for my hypothesis.

2.1 Board of directors' impact on ROE ROA EPS & BVE

In this literature we will see the effect of board structure which include both dependent and independent directors in risk management. The researcher in this literature considered both independent and dependent non-executive directors so that the researcher can check that how they perform in an organization and what is the impact of their performance in an organization. the researcher has seen that the independent directors are less likely to fail as compared to dependent directors. Moreover, the possibility of company failure is less when we compare independent directors with dependent directors as dependent directors are comparatively more prone to failures.

In the same way independent non-executive directors have more chances of success as compared to independent executive directors. On the other hand, we see that there is a negative effect between company's success and number of boards of independent directors, which means after a certain number risk of firm failure will increase. All of the above discussion shows that risk of firm is minimized when there is appropriate proportion of directors in a board structure. (Hsu, Hwa-Hsien and Wu 2014)

2.2 Ownership impact on ROE ROA EPS & BVE

In this literature we will examine the effect of board composition on risk minimization of a company and how does it affect the performance of the company. The data is taken from London Stock Exchange. The data taken by the researcher is of UK listed companies from year 1998 to year 2008. The researcher has used a panel data of 10 years and has applied econometric equation to find out the relation between board composition which include both dependent and independent directors with firm's performance and how it minimizes the risk of failure. The measurement used are accounting ratios and Tobin's Q. while controlling for a number of conditions external to the firm as well as business characteristics. From the analysis the researcher has found out that there is a positive effect of independent directors in firms' performance but after a specific limit performance decreases and risk of failure increases. (Poutziouris, et al. 2015)

The researcher in this literature analysis the effect of ownership structure and board composition on voluntary disclosure. By Ownership structure researcher means managerial ownership, block holder ownership and government ownership. By board composition the researcher meant number of independent directors in an organization. By Voluntary disclosure researcher means any disclosure of information whether financial or nonfinancial information. Researchers results show that ownership structure and board composition have an impact on voluntary disclosure. He found out that effect of ownership structure and board composition on voluntary disclosure is negative. (Eng & Mak, 2003)

From 1990s new debate has erupted which is corporate governance and its component. Many scholars have said that board of directors play an important role in performance of any organization. Still there were many financial crises because of corporate governance. Many corporate governance glitches have not been removed like biasness of independent directors etc. here the researcher analyzed the effect and importance of independent director in corporate governance and how it can affect firm's performance. The researcher has taken account the biasness which comes with independent directors. The researcher finds out the ethical version of board composition and that it negatively effects firms' performance and thus increasing risk of failure. (Nordberg, Donald and McNulty 2013)

In this literature the researcher is comparing the gender diversity in an organization. in this literature women directors will be compared against men directors. This literature will examine whether women as dependent director has any effect on firm's performance. According to this literature, women are more reserved in making aggressive or riskier decisions as compared to men. This literature also tells us that women directors perform better in companies with low debt compared to companies with high debt. In this paper it is concluded that when making bold decisions women directors are more reserved than men which effects firms' performance. (Arun, et al. 2015)

In this literature the researcher analyzed the factors by which an organization risk of failure increases nor decreases. The researcher for his study took the insurance companies of UK. The researcher used econometric equations to find out the effect of corporate governance components with firms' performance. From the model which the researcher made he made the connection between CG components and risk taking. From the analysis he found out that risk of failure will be low if board of directors would do frequent meeting and discuss financial matters of the company more often. (Eling and Marek 2014)

This paper presents the primary evidence showing that board of directors and the identity of the biggest shareholder depend on corporate profits, measured by way of a stock price-based timeliness metric and the reporting lag. the usage of panel Data of 1276 Malaysian companies from year 1996 to 2009, we discover a non-linear courting among concentrated possession, measured through the most important shareholding in a firm, and the reporting lag however no longer the timeliness of rate discovery. although corporations with authorities as the most important shareholder and political connections have a substantially shorter reporting lag, simplest the former are timelier in price discovery. corporations with own family and foreigners as the largest shareholder but are much less well timed in price discovery. at the same time as the reporting lag is shorter in the duration after the integration of the Malaysian Code of corporate Governance (MCCG) into Bursa listing policies, its impact on the timeliness of fee discovery is in most cases immaterial (Lim, How and Verhoeven 2014)

In this literature according to researcher board of directors is a cooperative body that acts in the best interest of shareholders. The board needs the mixture of dependent and independent directors to chase the stockholders' interest. Directors in the company cannot do their job if they had any external pressure that's why independent directors are appointed to minimize risk of failure. Moreover, there should be balance between dependent and independent director so that company's interest can be perused. The researcher also noted that too many independent directors decreases firm performance which increases the risk of failure. (SyedFuzi, AbdulHalim and M.K.Julizaer 2016)

This literature tells us about the relationship between corporate governance and organizations earnings. About more than 150 United States were taken as sample and analyzed the relation between corporate governance and earnings of those organizations. The research was conducted with the help of different research articles. Research found out that some of the components of corporate governance had no relation with earnings some had weak relation with earning and some had moderate or strong relation with earnings of an organization. Researchers also noted that there is weak impact of corporate governance when board of directors or CEO of firm is independent and there is strong relation of earnings with corporate governance when CEO or board of director has a parent owner. Researchers concluded that it was beneficial for a firm to have independent board of directors because it had a strong impact on earnings or profitability of firm. (Agrawal, 2005)

After the economic crisis of 2008 many corporate governance laws have changed to minimize risk of failure. The researcher in his study has made an index from which risk assessment of listed Malaysian companies is possible. This study stats hat for minimization of risk full disclosure is needed so that the company can be monitored externally as well as internally. (RajaAhmad, et al. 2015)

The researcher in this literature says that incentivize the investor a firm can go into riskier investments to gain more profit. Researcher in his research uses panel data analysis to find out risk assessment. Corporate governance is one of the variables he uses in his research and concludes that stronger Corporate governance would lead to risk avoidance. (John K. L., 2008)

In this literature the researcher finds out the role of independent directors in Malaysian firms in economic crisis of 2008. The researcher took the sample of 289 companies and analyzed that companies hired more independent directors who had skills and competency required by the firm. (Sharif and Yeoh 2014)

The researcher analyzed the effect of corporate governance by calculating corporate governance index 24. The index had 6 components staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, also supermajority requirements for mergers and charter amendments. The researcher said that the above six components had some impact on performance of a firm while other 18 had constant impact on firm's performance. (Bebchuk, 2008)

Researcher in this literature wants to examine the role of independent directors in Malaysian firms. Researcher for his research interviewed board members of 27 companies. The researcher found out that it was necessary to have independent directors so that small investors can be protected from any corrupt practice done by the company. Researcher also noted that independent directors main focus was on return on investment for their investment rather than participating in day to day activities. Researcher concluded that independent directors should also participate in day to day running of business. (Annuar and Rashid 2015)

2.1 Hypothesis

H1: Good corporate governance has a positive relationship with ROE.

H2: Good corporate governance has a positive relationship with ROA.

H3: Good corporate governance has a positive relationship with Book value of equity.

H3: Good corporate governance has a positive relationship with EPS.

2.2 Variables

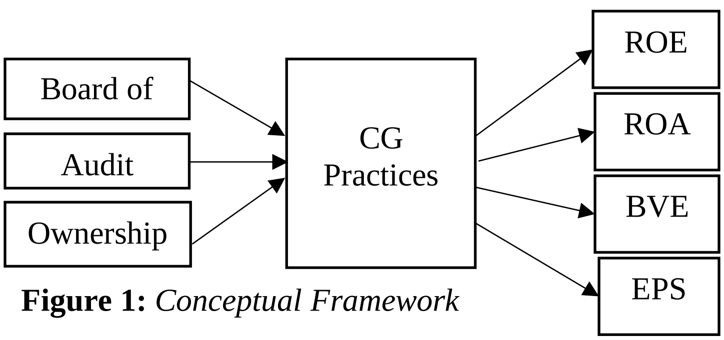

Figure 1: *Conceptual Framework*

III. Methodology and Data Sampling

3.1 Sampling of Data

Sample of banks of Pakistan. 10 banks as sample and took the financial statements from year 2013 to 2107. I have selected the banks which were listed on Pakistan stock exchange.

We collected the required data from Financial statements of following banks from year 2013 to 2017. The sample covers Islamic banks of Pakistan and commercial Banks of Pakistan. As said before we have selected corporate governance index as independent variable. We will be calculating the corporate governance index through benchmarking as done by (Attiya Y. Javid, 2010). We will only be following the procedure of the researcher. We will calculate numeric data of corporate governance so that we can analysis and compare it with dependent variables. From the analysis we can found out whether corporate governance has any effect on firm's financial performance.

3.2 Technique Used

For calculation and analysis, we used

- Financial ratio analysis

We will do this to calculate values for desired dependent variables. (Zagorchev, 2015)

- Linear Regression and Pearson Coefficient

We will apply the formula to check the relation between variables. (Zagorchev, 2015)

$$y = a + bx$$

We have sub categorized corporate governance into three components,

- Directors.
- ownerships.
- audit committee.

we have categorized it on the basis of past researches in which it was found out that these components have direct or indirect relation with performance of a firm. The following table will show us components of our independent variable.

IV. Result and Analysis

In this section we have taken different model and then run some test on them in order to know that results. First the model and its empirical result are given in the table and then the results are interpreted by the values showed in the table.

Habib Bank Limited

Model 1

		HCGI	HROE	HROA	HBE	HEPS
Pearson Correlation	HCGI	1.000	.851	.874	-.007	.862
	HROE	.851	1.000	.989	-.198	.972
	HROA	.874	.989	1.000	-.257	.945
	HBE	-.007	-.198	-.257	1.000	.036
	HEPS	.862	.972	.945	.036	1.000
Sig. (1-tailed)	HCGI	.	.034	.026	.495	.030
	HROE	.034	.	.001	.375	.003
	HROA	.026	.001	.	.338	.008
	HBE	.495	.375	.338	.	.477
	HEPS	.030	.003	.008	.477	.

From model 1 we can see that that from 5 variables selected corporate governance is correlated to every variable except that book value of equity has a negative relation towards corporate governance. Highest and positive correlation with corporate governance is of earning per share of .862.

In the same way every variable is significant with the independent variable Corporate index with book value of equity having most significance of .495.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

MCB Bank Limited

Model 2

		MCBCGI	MCBROE	MCBROA	MCBBE	MCBEPS
Pearson Correlation	MCBCGI	1.000	-.692	-.818	.480	-.960
	MCBROE	-.692	1.000	.946	-.702	.705
	MCBROA	-.818	.946	1.000	-.826	.806
	MCBBE	.480	-.702	-.826	1.000	-.443
	MCBEPS	-.960	.705	.806	-.443	1.000
Sig. (1-tailed)	MCBCGI	.	.098	.045	.207	.005
	MCBROE	.098	.	.007	.093	.092
	MCBROA	.045	.007	.	.043	.050
	MCBBE	.207	.093	.043	.	.228
	MCBEPS	.005	.092	.050	.228	.

From model 2 we can see that that from 5 variables selected corporate governance is correlated to every variable except that book value of equity has a positive relation towards corporate governance. Highest and negative correlation with corporate governance is of earning per share of .960.

In the same way every variable is significant with the independent variable Corporate index with book value of equity having most significance of .207.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

Askari Bank Limited

Model 3

		AKBLCGI	AKBLROE	AKBLROA	AKBLBE	AKBLEPS
Pearson Correlation	AKBLCGI	1.000	.803	.792	.720	.820
	AKBLROE	.803	1.000	1.000	.748	.994
	AKBLROA	.792	1.000	1.000	.740	.992
	AKBLBE	.720	.748	.740	1.000	.815
	AKBLEPS	.820	.994	.992	.815	1.000
Sig. (1-tailed)	AKBLCGI	.	.051	.055	.085	.044
	AKBLROE	.051	.	.000	.073	.000
	AKBLROA	.055	.000	.	.076	.000
	AKBLBE	.085	.073	.076	.	.046
	AKBLEPS	.044	.000	.000	.046	.

From model 3 we can see that that from 5 variables selected corporate governance is correlated to every variable and more over every variable has a positive relation towards corporate governance. Highest correlation with corporate governance is of earning per share of .085. it shows weak relation between dependent and independent variable

In the same way every variable is significant with the independent variable Corporate index with book value of equity having most significance of .207.

We can also see that all variables are not significant and but are correlated with each other. From this analysis we have proved that Corporate governance has a weak relation with each of the four independent variables.

Silk bank Limited

Model 4

		SilkCGI	SilkROE	SilkROA	SilkBE	SilkEPS
Pearson Correlation	SilkCGI	1.000	.896	.861	-.150	.794
	SilkROE	.896	1.000	.953	.023	.895
	SilkROA	.861	.953	1.000	.000	.981
	SilkBE	-.150	.023	.000	1.000	.138
	SilkEPS	.794	.895	.981	.138	1.000
Sig. (1-tailed)	SilkCGI	.	.020	.031	.405	.054
	SilkROE	.020	.	.006	.485	.020
	SilkROA	.031	.006	.	.500	.002
	SilkBE	.405	.485	.500	.	.412
	SilkEPS	.054	.020	.002	.412	.

From model 4 we can see that that from 5 variables selected corporate governance is correlated to every variable except that book value of equity has a negative relation towards corporate governance. Highest and positive correlation with corporate governance is of return on equity of .896.

In the same way every variable is significant with the independent variable Corporate index with book value of equity having most significance of .405.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables. Though some variables are weakly correlated.

Meezan Bank Ltd

Model 5

		MeezanCGI	MeezanROE	MeezanROA	MeezanBE	MeezanEPS
Pearson Correlation	MeezanCGI	1.000	.165	.227	-.361	-.496
	MeezanROE	.165	1.000	.973	-.963	-.385
	MeezanROA	.227	.973	1.000	-.989	-.582
	MeezanBE	-.361	-.963	-.989	1.000	.599
	MeezanEPS	-.496	-.385	-.582	.599	1.000
Sig. (1-tailed)	MeezanCGI	.	.396	.357	.276	.198
	MeezanROE	.396	.	.003	.004	.261
	MeezanROA	.357	.003	.	.001	.152
	MeezanBE	.276	.004	.001	.	.143
	MeezanEPS	.198	.261	.152	.143	.

From model 5 we can see that that from 5 variables selected corporate governance is correlated to every variable except that book value of equity and earning per share has a negative relation towards corporate governance. Highest and negative correlation with corporate governance is of earning per share of -.469.

In the same way every variable is significant with the independent variable Corporate index with return on equity having most significance of .396.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

Bank of Punjab Ltd

Model 6

		BOPCGI	BOPROE	BOPROA	BOPBE	BOPEPS
Pearson Correlation	BOPCGI	1.000	.003	.105	.352	.436
	BOPROE	.003	1.000	.993	.622	.778
	BOPROA	.105	.993	1.000	.687	.822
	BOPBE	.352	.622	.687	1.000	.896
	BOPEPS	.436	.778	.822	.896	1.000
Sig. (1-tailed)	BOPCGI	.	.498	.433	.280	.232
	BOPROE	.498	.	.000	.131	.061
	BOPROA	.433	.000	.	.100	.044
	BOPBE	.280	.131	.100	.	.020
	BOPEPS	.232	.061	.044	.020	.

From model 6 we can see that that from 5 variables selected corporate governance is correlated to every variable except that book value of equity has a positive relation towards corporate governance. Highest and negative correlation with corporate governance is of earning per share of .960.

In the same way every variable is significant with the independent variable Corporate index with book value of equity having most significance of .207.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

Bank Alfalah Limited

Model 7

		AlfaCGI	AlfaROE	AlfaROA	AlfaBE	AlfaEPS
Pearson Correlation	AlfaCGI	1.000	-.228	.650	.605	.478
	AlfaROE	-.228	1.000	-.223	-.563	-.553
	AlfaROA	.650	-.223	1.000	.913	.903
	AlfaBE	.605	-.563	.913	1.000	.987
	AlfaEPS	.478	-.553	.903	.987	1.000
Sig. (1-tailed)	AlfaCGI	.	.356	.118	.140	.208
	AlfaROE	.356	.	.359	.161	.167
	AlfaROA	.118	.359	.	.015	.018
	AlfaBE	.140	.161	.015	.	.001
	AlfaEPS	.208	.167	.018	.001	.

From model 7 we can see that that from 5 variables selected corporate governance is correlated to every variable except that return on equity has a negative relation towards corporate governance. Highest and positive correlation with corporate governance is of return on assets of .650.

In the same way every variable is significant with the independent variable Corporate index with return on equity having most significance of .356.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

Bank AL Habib Limited

Model 8

		AlfaCGI	AlfaROE	AlfaROA	AlfaBE	AlfaEPS
Pearson Correlation	AlfaCGI	1.000	-.228	.650	.605	.478
	AlfaROE	-.228	1.000	-.223	-.563	-.553
	AlfaROA	.650	-.223	1.000	.913	.903
	AlfaBE	.605	-.563	.913	1.000	.987
	AlfaEPS	.478	-.553	.903	.987	1.000
Sig. (1-tailed)	AlfaCGI	.	.356	.118	.140	.208
	AlfaROE	.356	.	.359	.161	.167
	AlfaROA	.118	.359	.	.015	.018
	AlfaBE	.140	.161	.015	.	.001
	AlfaEPS	.208	.167	.018	.001	.

From model 8 we can see that that from 5 variables selected corporate governance is correlated to every variable except that return on equity has a negative relation towards corporate governance. Highest and positive correlation with corporate governance is of return on assets of .650.

In the same way every variable is significant with the independent variable Corporate index with return on equity having most significance of .356.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

Bank Islami Pakistan Limited

Model 9

		BIPLCGI	BIPLROE	BIPLROA	BIPLBE	BIPLEPS
Pearson Correlation	BIPLCGI	1.000	.864	.861	.952	.867
	BIPLROE	.864	1.000	.999	.969	.999
	BIPLROA	.861	.999	1.000	.966	.997
	BIPLBE	.952	.969	.966	1.000	.971
	BIPLEPS	.867	.999	.997	.971	1.000
Sig. (1-tailed)	BIPLCGI	.	.029	.030	.006	.029
	BIPLROE	.029	.	.000	.003	.000
	BIPLROA	.030	.000	.	.004	.000
	BIPLBE	.006	.003	.004	.	.003
	BIPLEPS	.029	.000	.000	.003	.

From model 9 we can see that that from 5 variables selected corporate governance is correlated to every variable and every variable has a positive relation towards corporate governance. Highest and positive correlation with corporate governance is of book value of equity of .952.

In the same way every variable is significant with the independent variable Corporate index with return on assets having most significance of .030.

We can also see that all variables are not significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables. Secondly relation and significance between independent and dependent variable is weak.

Soneri Bank Ltd

Model 10

		SonariCGI	SonariROE	SonariROA	SonariBE	SonariEPS
Pearson Correlation	SonariCGI	1.000	.767	.234	.766	.843
	SonariROE	.767	1.000	.795	.658	.955
	SonariROA	.234	.795	1.000	.186	.621
	SonariBE	.766	.658	.186	1.000	.852
	SonariEPS	.843	.955	.621	.852	1.000
Sig. (1-tailed)	SonariCGI	.	.065	.352	.066	.037
	SonariROE	.065	.	.054	.114	.006
	SonariROA	.352	.054	.	.382	.132
	SonariBE	.066	.114	.382	.	.033
	SonariEPS	.037	.006	.132	.033	.

From model 10 we can see that that from 5 variables selected corporate governance is correlated to every variable and every variable has a positive relation towards corporate governance. Highest correlation with corporate governance is of EPS of .843.

In the same way every variable is significant with the independent variable Corporate index with return on assets having most significance of .352.

We can also see that all variables are significant and correlated with each other. From this analysis we have proved that Corporate governance has relation with each of the four independent variables.

V. Conclusion and Discussion

At the start of the research I had following hypothesis,

- Good corporate governance has appositive relationship with ROE.
- Good corporate governance has appositive relationship with ROA.
- Good corporate governance has appositive relationship with Book value of equity.
- Good corporate governance has appositive relationship with EPS.

Through my research we can conclude that in all the banks which we took as sample all showed a relation between corporate governance while in some banks like MCB earning per share and return on asset had negative effect. In some cases, weak relation between the variables was noticed. In the same way when dependent variables were correlated with each other through Pearson correlation we found out that except for a few cases all variables had positive correlation. In the end we can verify that the hypothesis which we made at the start has been proved.

Through my research WE can conclude that in all the banks which WE took as sample all showed a relation between corporate governance while ratios in different banks like ROE, earning per share and return on asset had negative effect. In some cases, weak relation between the variables was noticed. In the same way when dependent variables were correlated with each other through Pearson correlation we found out that all most every variable was either significant or correlated with each other.

5.1 Limitations

Although we tried to cover every aspect of corporate governance relation with firm performance, this research has some limitations.

- we had a time constraint due to which we weren't able to cover all of the population
- There could be a relation between corporate governance of financial and nonfinancial institution.
- The model we used was only linear regression and multiple regression whereas econometric analysis can also be done to verify the results.

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Index 1: The Board of directors

Board size (number of directors)	5%
Board composition (clear cut job description of all board members)	5%
Chairman CEO separation (if not any lead director)	5%
Outside directors available to board (independent director, nominee directors)	5%
Board attendance (board meetings)	5%
Outside directors attendance in meetings	5%
Existence of the position of CFO	5%
Directors representing minority shareholders	5%

Index 2: Ownership and Shareholdings

Presence of outside block holders(more than 10% shareholdings)	5%
Does the CEO own shares	5%
Director ownership (block ownership) other than CEO and chairman	5%
Chairman and CEO in block holder (10 percent)	5%
Concentration of ownership (top five)	5%
Dividend policy	5%
Staff benefits other than salaries	5%

Index 3: Transparency, Disclosures and auditing

Does the company has a full disclosure of corporate governance practices	5%
Does the company disclose how much it paid to its auditor for consulting and other work.	5%
Does the company disclose the full biographies of its board members	5%
Disclosure of internal audit committee	5%
Disclosure of board directors and executive staff members remuneration	5%
Disclosure in the company's annual report of ownership according to the requirement of the code	5%
Information of the executive management staff members ownership (employees ownership)	5%