

# Variables affecting Corporate Governance in the Profitability of Banks in Pakistan

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## Abstract

Purpose: Understanding the issue of Corporate Governance requires thinking beyond the Profit maximization for the firm. Corporate governance is the effective control of the issue regarding top management. Corporate governance is the major element of the present international business system. This research therefore investigates the connection between

corporate governance and financial institutions profitability in Pakistan.

**Methodology:** For this purpose a questionnaire is being adapted and responses are gathered from the executive body in banks of all the three divisions of Southern Punjab.

**Findings:** The research found that good corporate governance is necessary for the profitability in banks.

**Limitation:** The limitation of the study is that we had a small sample size due to the time constraint but it provides a research framework for future studies.

**Keywords:** Corporate Governance, Board Size, Performance Measurement System, Management Interaction, Strategic Planning & Performance.

## 1. Introduction

This paper focuses on the factors that affect corporate governance and the profitability of banks. Corporate governance system is the governance of company by the Board of directors and shareholders. Shareholders are the real owners of the company but they cannot manage it. Management consists of a team of professionals while in BOD there are the major shareholders who have a larger share. Corporate governance comes from the top of the company, and it includes the management of internal affairs as well as managing the links with external one.

In some researches this concept has been introduced to solve the problems (Fama 1980, Fama and Jensen 1983, Turnbull 1997) one is internal mechanism, such as compensation of the managerial staff, BOD, control by major shareholder. (Jensen, 1986) and second mechanism is external means the market for the managers and for the products and services, its management and control. But the application of this mechanism requires the system that has been operated and accepted in the country or in the firm.

To identify the factors that might influence an organization's corporate governance and its profitability most of organizations conduct interviews or feedback surveys. Both of these methods have advantages as well disadvantages. For the reliable results one should be careful about selecting the method. For this study the questionnaire method is selected and they are filled by the regional heads of various public sector banks of Southern Punjab.

The objective of this study is to find the most influencing variables through corporate governance may be effective and in turn what is the role of corporate governance in profitability of the banks. Board Size, Management Interaction, Performance Measurement System and Strategic Planning & performance were selected as independent variables to see its impact on corporate governance and the impact of corporate governance on banks' profitability.

This study is conducted to find the results of following questions:

1. Is there any impact of Board size on corporate governance?
2. Is performance measurement system is positive correlated with the corporate

governance?

3. Is there any effect of management interaction?
4. What is the effect of Strategic planning and performance on corporate governance?
5. Has corporate any role in the profitability of banks?

## **2. Literature Review**

### **Corporate Governance:**

Corporate governance is the efficient control of the top level management over the organization. The mechanism of corporate governance adopted depends upon the system that is being used in the country, whether it is market oriented or large shareholder oriented (Franks and Mayer, 1997; Shleifer and Vishny, 1997). The mechanism of corporate governance may differ from organization to organization (Mayer, 1996). Large shareholders may lead to the good corporate governance (Cadbury Commission, 1992). The desirability of the good corporate governance activity and the greater efficiency in the operations can yield maximum benefits (Kester, 1997). Blair (1995) defines corporate governance in the wider sense and argued that “corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific assets.”

Shleifer and Vishny defined corporate governance as dealing “with the ways that suppliers of finance to corporations assure themselves of getting a return on their investment” (1997, p. 737).

The governance of banking companies might be different from the unregulated, non financial companies due to many reasons. First, the number of stakeholders in an institution’s operations complicates the governance in financial institutions. Second, investors, regulators and depositors (customers) have been directly interested in banks. (Fama 1980, Jensen 1993, and Hart 1983)

### **Board Size:**

Chugh, Meador & Kumar (2011) found that a greater the board size means greater opportunities and resources for better financial performance. Coleman (2007) derived that the larger the size of the board can enhance corporate governance. Cheng Wu, Chiang Lin, I-Cheng & Feng Lai (2005) concluded that board size is negatively and significantly related to firm performance and governance. Cheng Wu, Chiang Lin, I-Cheng & Feng Lai (2005) and Javid & Iqbal (2008) found that board composition is positively and significantly related to firm performance. Yung in 2009 confirmed that the board size has a greater impact on bank’s profitability and good governance using panel regression method.

***H1: Board size positively affects corporate governance***

### **Performance Measurement System:**

There are three elective methods for deciphering the unrivaled return execution of organizations with solid shareholder rights. Initially, these outcomes could be example-period

particular; thus organizations with solid shareholder rights throughout the current decade of 2000s might not have shown prevalent return execution. Actually, in an extremely late paper, Core, Guay and Rusticus (2005) precisely record that in the current decade offer returns of organizations with solid shareholder rights don't beat those with feeble shareholder rights. Second, the danger alteration may not have been carried out appropriately; as such, the influence element may be corresponded with some undetectable danger factor(s). Third, the connection between corporate legislation and execution may be endogenous raising questions about the causality description.

### ***H2: Performance Measurement System Positively effects corporate governance***

#### **Management Interaction:**

The shareholders, employees and other stakeholders of the company have a combined interest in the organization, they are always been capable to adjust with the changing demands allowing the company to be more adjusting according to the changing demands. Positive interaction between shareholders, board of directors and management is therefore necessary for better corporate governance. Shareholders exercise their influence in general meetings, so they should appropriately use their right for the better decision of the company. good corporate governance depends on the ideas which make it convenient for the board of directors to enter into a discussion with the management of the company. This can only be done if the boards of directors as well as all the shareholders are well informed about company situation and the annual general meeting provides a platform for the communication and the discussion of all the shareholders. (Committee on Corporate Governance)

### ***H3: Management Interaction positively effects corporate governance***

#### **Strategic Planning & Performance:**

Strategic planning and performance is central for a company to make critical decisions and is the base for the operating planning. It affects corporate governance that if one has good strategic planning then its corporate governance might be more effective. Board of Directors should understand the need of strategic planning in corporate governance. Its failure can lead to disagreements between the Board and he CEO. (Kinross, 2012)

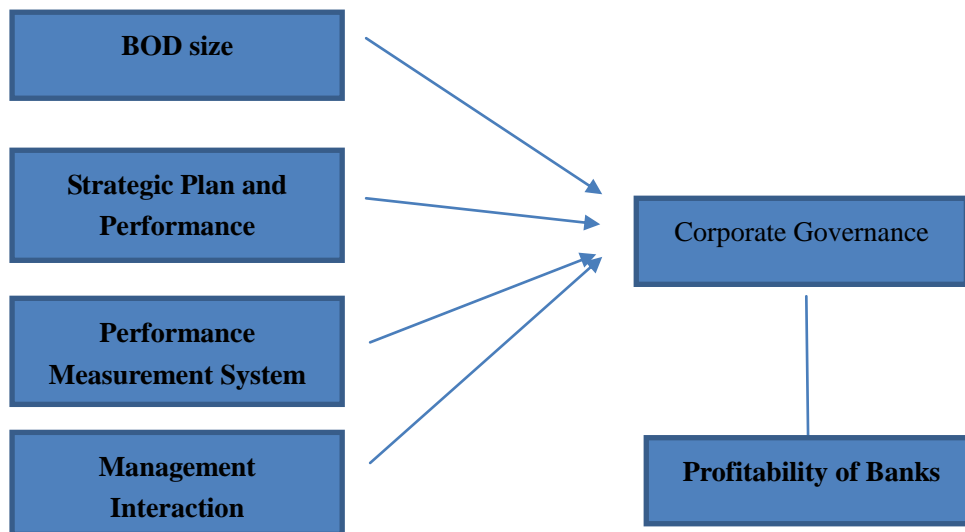
### ***H4: Strategic Planning and Performance positively effects corporate governance***

#### **Profitability:**

Profitability can be measured in many ways for example, return on assets or on investment etc., Spon and Sullivan (2007) in a study found that banks ownership and several governance features with the profitability, that they correlated. However, corporate governance has a positive relation with the profitability in banks. With the change in the variables of corporate governance i.e. board size, and size of shareholders the profitability also effected very much (Akpan and Riman, 2012)

### ***H5: Corporate Governance Positively effects Profitability of Banks***

### 3. Research Model



### 4. Methodology

A survey is being conducted in banks with some Corporate Governance related questions and for this purpose a questionnaire is being adapted, that contain six sections and each section represent each variable. The scales have been adapted in following sources:

1. Genome Canada, Board Of Directors, Annual Questionnaire, 2008
2. CMDA has introduced a corporate governance framework in 2007 with the aim of improving corporate governance practices in the country.

For the purpose of data collection regional heads of various public sector banks in Southern Punjab are being visited and got the questionnaires filled from 15 members of executive body. The responses and the analysis of their output have been discussed in next section.

### 5. Results and Analysis

According to the model, there were sections. In the first section Board Size, Management Interaction, Strategic Planning & Performance and Performance Measurement System were selected as independent variables and saw its effect on dependent variable that was Corporate Governance. The equation is as follows:

$$Y = \alpha + \beta_1 (BS) + \beta_2(PMS) + \beta_3(MI) + \beta_4 (SPP)$$

<b>Coefficients<sup>a</sup></b>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.765	.601		-1.272	.232
	BS	.052	.198	.072	.263	.798
	PMS	.306	.436	.069	.702	.499
	MI	.519	.158	.581	3.287	.008
	SPP	.692	.268	.337	2.585	.027
a. Dependent Variable: CG						

When the regression analysis was being applied the results revealed that the impact of Strategic Planning Performance and Management Interaction is more significant on Corporate Governance as compared to other variable; which shows that more focus on these variables create more efficiency in this corporate governance for banks. In order to find the extend of this fact, correlation analysis was done that shows that the management interaction was highly positively correlated with the CG while the SPP is moderately correlated.

$$CG = 0.519 (MI) + 0.692 (SPP)$$

<b>Coefficients<sup>a</sup></b>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.006	.143		.041	.968
	CG	1.066	.107	.940	9.920	.000
a. Dependent Variable: P						

The impact of CG on Profitability is also highly significant, it shows that when the banks should focus on the policy of the corporate governance one times in response it increases banks' profitability 1.066 times. The other two variables show less significance towards CG, due to the reason that sample size was small and geographical area was also limited if this research is conducted nationwide and sample size would be large then it might be possible that the results may vary and show different responses.

<b>Correlations</b>							
		CG	BS	PMS	MI	SPP	P
CG	Pearson Correlation	1	.955**	.580*	.953**	.912**	.940**
	Sig. (2-tailed)		.000	.023	.000	.000	.000
	N	15	15	15	15	15	15
BS	Pearson Correlation	.955**	1	.691**	.919**	.897**	.947**
	Sig. (2-tailed)	.000		.004	.000	.000	.000
	N	15	15	15	15	15	15
PMS	Pearson Correlation	.580*	.691**	1	.468	.564*	.515*
	Sig. (2-tailed)	.023	.004		.079	.029	.049
	N	15	15	15	15	15	15
MI	Pearson Correlation	.953**	.919**	.468	1	.811**	.942**
	Sig. (2-tailed)	.000	.000	.079		.000	.000
	N	15	15	15	15	15	15
SPP	Pearson Correlation	.912**	.897**	.564*	.811**	1	.909**
	Sig. (2-tailed)	.000	.000	.029	.000		.000
	N	15	15	15	15	15	15

P	Pearson Correlation	.940**	.947**	.515*	.942**	.909**	1
	Sig. (2-tailed)	.000	.000	.049	.000	.000	
	N	15	15	15	15	15	15
** . Correlation is significant at the 0.01 level (2-tailed).							
* . Correlation is significant at the 0.05 level (2-tailed).							

The correlation among the variables of the study, mostly show significant results, it represents that the variables are highly correlated and this validate the model.

## 6. Conclusion

This research is an attempt to find out the variables that might affect the corporate governance. Corporate is necessary of the firms operating on large scale. Because there are a number of operations and a large number of stakeholders and for the internal and external operations as well as strategic planning corporate governance is necessary. The research has found that management interaction and the strategic planning and performance are the key variables that would affect the firm. Meanwhile found corporate governance as a significant measure to enhance the profitability. As the area of concentration was banks therefore in banks corporate governance is required as the customers as well as the investors are directly interested in the performance of their bank. Pakistan's banking sector is strong enough to bear the unfavorable shocks, the reason might be this that Pakistan's Banking sector has good corporate governance.

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