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Corporate Governance Framework and Financial Performance of Nepalese Banking Sector

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Abstract:- The aim of the study is to examine the corporate governance framework and financial performance of Nepalese banking sector. The framework of corporate governance was operationalized by using two variables such as the size of a board and board gender diversity which formed the independent variables while the bank's profitability is measured in terms of return on equity and return on assets are two dependents variables used in this study. The secondary data are obtained from the annual reports of concerned banks during 5 year period starting from 2014 to 2018. The population of commercial banks operating in the nation is 27 but the study covers only 10 banks as sample banks. Descriptive statistics analysis is used to describe the variables used in the study. In addition, the correlation analysis model is used to examine the relationship between the framework of corporate governance and the financial performance of banks. The results of the study indicated that there are mixed findings regarding the board size on financial performance and a negative relationship between board gender diversity on return on equity and return on assets.

Keywords:- *Corporate Governance, Board Size, Board Gender Diversity, Financial Performance.*

I. INTRODUCTION

Commercial banks are established to improve the public economic welfare by offering banking services, to mobilize the deposit amount into a different loan to the individual, private and public sectors. Thus, commercial banks have been playing a vital role in the growth of the nation directly or indirectly. According to Banking and Financial Institutions Act, 2063 (2006 A.D.) (BAFIA), Nepalese banks and financial institutions are classified into A, B, C, and D classes. This BAFIA Act 2063 incorporates the banking law and regulation, financial good governance and maintaining financial stability and promotion of transparency and protection of depositors' deposit. In the context of Nepal, Nepal Rastra Bank is the supreme bank. It is also called the Central bank. The Central bank has the full right authority to issue a license to banks and financial institutions. Therefore, Nepal Rastra Bank has kept the commercial banks as "A" class financial institutions. The main functions of commercial banks are to provide various services like accepting deposits from the general public, making business loans, and also stand as a bridge between savers to investors in the economy. These institutions are generally run to make a profit by offering different financial services in an economy. Today, 27 commercial banks are operating in the nation. The first commercial bank of Nepal is the Nepal Bank Limited (NBL), which was established on November 15, 1937 A.D. later on, Nepal Rastra Bank (NRB) was established on April 26, 1956 A.D under the Nepal Rastra Bank Act 1955 AD, to regulate the financial sector of the nation. Likewise, Rastriya Banijya Bank (RBB) was established on January 23, 1966, under the RBB Act, to provide a wide range of financial services to the customers, insurance companies, and industrial sectors.

Corporate Governance can be explained as the combination of well-defined rules, procedures, laws, and functions of business activities that take place within a company. Thus, it is a framework of corporate policies and practices used by the corporate members in achieving their objectives. The main duties of corporate governance are to protect the right of the stockholders, disclosure, and transparency of financial matters, facilitate the board functioning decision, and also provide the legal framework in a company. Therefore, the main structure of corporate governance includes the directors, management team, and the stockholders of a company. The Organisation for Economic Cooperation and Development (OECD) in 1999 explained corporate governance as "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, and shareholders, and other stakeholders, and spells out the rules and procedures for deciding on corporate affairs. By doing this, it also provides the structure through which the company objectives and monitoring performance". The framework of corporate governance is more important for the banking sector than other companies because it plays a crucial role in the development of financial activities in an economy. The structure of corporate governance is important to the public and private sectors, including laws and regulations, and accepts the firm practices which together work between managers and entrepreneurs in one side, and the investors who are ready to invest their resources in a company on the other side (Lu & Batten, 2001).

II. STATEMENT OF THE PROBLEM

The framework of corporate governance refers to the number of directors in a board, managers, company stockholders, and other concerned stakeholders of a company. However, to run the banking and financial sectors effectively, a good framework of corporate governance must be made and implement in the right direction. Thus, the corporate structure is more essential for banking and financial sectors whether they are in developed or developing countries. Looking towards the developing countries, the effectiveness of corporate governance framework in financial sectors is looking unsatisfactory. Therefore, the study examines the size of the board and gender diversity in a board to identify the bank's performance. Many researchers have been studied on this topic and found the mixed results regarding board size, gender diversity in a board, and bank's financial performance. Thus, in reality, this study is conducted to identify the actual corporate governance framework used in Nepalese banking sectors.

III. OBJECTIVES

The specific objectives of the study are:
i) To identify the corporate governance framework and commercial banks' performance in Nepal.
ii) To investigate the relationship between board size and board gender diversity with commercial banks' performance in Nepal.

IV. REVIEW OF LITERATURE

This section discusses the previous related literature about the corporate framework and banks' performance.

4.1 Corporate Governance

According to Bank and Financial Institutions Act, 2063 (2006 A.D.) explained that the framework of corporate governance including the proper defining the authority and responsibilities of board members, qualification required of directors, board governance system, and function of independent directors, transparent financial reporting a company, and disclosure practices in a firm. The lack of transparency and disclosure practices is one of the problems of corporate governance in recent years which harms people's confidence towards the banking sectors. According to Adhikari (2014), the Nepalese financial sector still needs to develop good governance practices to become a more reliable and efficient sector of the economy. Melvin and Hirt (2005) defined corporate governance as "firm decision making, management, particularly in the context of the board of directors and its operating procedures in a business." They also clarified that the term "corporate governance" is used in a variety of contexts, encompassing a company's interactions with a broad spectrum of stakeholders or more specifically referring to a company's adherence to the provisions of the law. According to Imam and Malik (2007), corporate governance is a theoretical term that involves the regulation and management of corporate factors to promote the efficient use of firm resources. The relationship between the shareholders, board of directors, and executives in deciding the course and performance of the company's activities is described as a corporate governance structure.

4.2 Board Size

The board size is described by Panasian et al., (2003) Levrau & Van den Berghe (2007) as the total number of directors associated with a business. According to Goshi et al. (2002), the optimal number of board members in a company must be made up of executive and non-executive directors.

According to John and Senbet (1998), board size is one factor that influences the efficiency of the board's monitoring feature. Indeed, the size of a company's board of directors has little bearing on its effectiveness. The number of factors such as outside executives, female directors, and people with a strong finance and accounting background determines the efficacy of board size. So far, there has been no specific agreement on the size of the company's board of directors. As a result, there are reasons for both smaller and larger board sizes being successful in managing managers' activities. There is also a case to be made that a bigger board of directors brings in more intellectual resources, boosting its efficiency in terms of controlling and advising management. However, critics argue that when a board becomes too large, it becomes difficult to control, promotes free-riding, and creates issues. According to Stepanova and Ivantsova (2012), a smaller board size reduces the risk of free riding and increases individual director responsibility. The relationship between board size and efficiency, according to Lehn, Patro, and Zhao (2009), can vary not only by firm-specific characteristics but also by national and institutional characteristics. As a result, the previous study found that empirical studies on board size and the financial performance of a company yielded mixed results. According to studies conducted by John and Senbet (1998), Dalton et al. (1999), Kiel and Nicholson (2003), Adams and Merhan (2008), Uadiale (2010), Javed et al. (2013), Poudel and Hovey (2013), a larger board of directors led to better financial results. On the other hand, M. C (1993), Staikouras, Staikouras, and Agoraki (2007), Adnan, Htay, Rashid, and Meera (2011), Ranti (2011), Alabdullah, Yahya, and Ramayah (2014) discovered that banks with smaller boards perform better. Jensen (1983) stated that for a board to operate efficiently, it should have a maximum of seven or eight members in the board. According to Jensen (1986), a smaller board size improves communication, cohesiveness, and teamwork in a group, allowing for more efficient monitoring. Furthermore, according to Adams and Merhan (2005), Horváth and Spirollari (2012), Htay (2012), and Velnampy (2013), the size of a company's board of directors has no significant results with the performance of the banks.

4.3 Board Gender Diversity

Hillman and Cannella (2007) studied that women directors are increasing in trend in a company as boards of directors, but their representation in a board is not similar. So, the sex ground is one of the board diversity qualities measurements. In other words, board diversity in a company

is occupied by the number of female directors on each board. Theories are backing the commitment by female executives performed better decision regarding corporate issues. In addition, legislative changes also the main part of the company to include female directors in the board in a company. Romano et al., (2012), Dutta and Bose (2007), found that the participation of female directors on boards of directors is small, even though the literature shows a slow but steady rise in female presence on corporate boards across the nation. According to Lakhal, Aguir, Lakhal, and Malek (2015) studied that women directors are more realistic in their monitoring portion of the business, and they are also considered an important part of corporate governance practices. Thus, the findings of the previous empirical results based on the impact of board gender diversity on a firm's financial performance were mixed and inconclusive. Abubakar, Garba, Sokoto, and Maishanu (2014) investigated the connection between corporate board gender diversity and firm success, concluding that gender diversity has an important and positive impact on financial performance. According to Pathan and Faff (2013) studied that gender diversity and bank performance have a positive relationship, Similarly, Julizaerma and Sorib (2012) found a positive linkage between gender diversity and a company's financial results in Malaysian publicly traded companies. Besides, Carter, Simkins, and Simpson (2003) indicated that there is a significant positive relationship between the female directors in a board and the value of the firm. Gautam (2019) investigated the impact of corporate governance on the performance of commercial banks in Nepal, discovered that having women on the board of directors has a positive relationship with return on assets (ROA) and a negative relationship with return on equity (ROE). On the contrary, previous empirical studies have shown that there is no significant connection between board gender diversity and a company's performance. According to Horváth and Spirollari (2012), Bukar and Ahmed (2020). Gender diversity had a substantial positive impact on return on assets, but no significant effect on return on equity,

4.4 Financial Performance

ROA and ROE are two basic accounting tools that are used to measure the effectiveness of a bank’s financial performance. These tools are also used in a research paper by the researchers (Hermalin & Weisbach, 1991; Yermach, 1996; Bhagat & Black, 2002; Abdullah, 2004; Lam & Lee 2012; Fanta, Kemal & Waka, 2013; Velnampy, 2013). ROA is calculated as follows.

$$ROA = \frac{\text{Profit after tax}}{\text{Assets}}$$

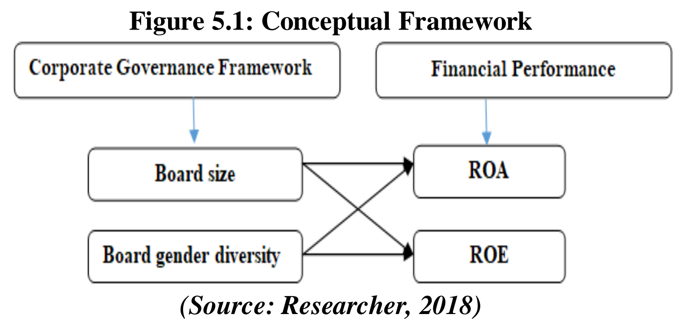
The return on equity is a metric that measures how much money a company's common stock owners make on their investments. A higher ratio means a higher profit. The formula is as follows:

$$ROE = \frac{\text{Profit after tax}}{\text{Shareholders}'\text{Equity}}$$

V. CONCEPTUAL FRAMEWORK

The conceptual structure is shown in the diagram below.

Figure 5.1: Conceptual Framework



(Source: Researcher, 2018)

VI. METHODOLOGY

The study applied descriptive and quantitative research designs. The total population of commercial banks is 27 in which Rastriya Banijya Bank is 100 percent government-owned commercial bank, likewise, Nepal Bank Limited - 40.5 percent government-owned commercial bank, and the Agricultural Development Bank - 51 percent government-owned commercial bank and rest 49 percent occupied by the general public. Thus, these 3 government-owned banks play important role in depositing and lending money in the Nepalese banking sectors. Out of 27 commercial banks, 10 sample banks were chosen using the judgmental sampling technique. The study covers 5 years of data from 2014 to 2018. Secondary data was gathered from bank annual reports, the central bank's website, and the Nepal stock exchange. Board size and board gender diversity were used as proxies for corporate governance framework variables. The proxies for the financial performance of the bank's return on assets and return on equity. The data were analyzed using statistical tools. The research aims to determine the relationship between corporate governance framework and bank financial performance. To generalize the study's results, descriptive statistics and correlation matrix methods were used.

VII. RESULT AND DISCUSSION

7.1 Descriptive Statistics Analysis

Table 7.1: Descriptive statistics results

Variables	N	Minimum	Maximum	Mean	Std. Deviation
Return on Equity (ROE)	50	-26.88	36.04	17.0010	8.95153
Return on Assets (ROA)	50	-1.44	2.89	1.6390	0.63533
Board Size	50	5.00	9.00	6.6000	1.12486
Board Gender Diversity	50	0.00	2.00	0.6000	0.67006

Table 7.1 shows the descriptive and statistical results of ROE, ROA, board size, and board gender diversity of sample banks. The average number of people on the board was 6.6000 (nearly, 7), with a standard deviation of 1.12486. (Approx. to1). The data appears to be very similar to the mean value, as shown by the lower standard deviation. As a result, the total number of board members in sample banks was found to be between 5 and 9. Similarly, board gender diversity had a mean of 0.6000 and a standard deviation of 0.67006. As a result, the total number of female directors in the sample banks was estimated to be between 0 and 2.Similarly, over the last five years, the average ROE was 17.0010, with a standard deviation of 8.95153. As a result, the average ROE ranged from -26.88 to 36.04. Likewise, the average ROA was 1.6390, with a standard deviation of 0.63533. According to this, the average ROA was between -1.44 and 2.89.

7.2 Correlation Matrix for the Dependent and Independent variables

Table 7.2: Correlation Matrix result for the Dependent and Independent variables

		Return on Equity (ROE)	Return on Assets (ROA)
Board Size	Pearson Correlation	0.003	-0.144
	Sig. (2-tailed)	0.985	0.317
Board Gender Diversity	Pearson Correlation	-0.044	-0.040
	Sig. (2-tailed)	0.760	0.784
	N = 50		

*** Correlation is significant at the 0.01 level (2-tailed)*
** Correlation is significant at the 0.05 level (2-tailed)*

Table 7.2 depicts the correlation matrix result for the dependent and independent variables. To examine the relationship between two given variables then correlation analysis can be used. A positive correlation means that two or more variables have a significant relationship. On the other hand, a poor correlation means that the variables are unrelated. The correlation coefficient shows the strength and weakness between the two variables. It can range from -1.00 to + 1.00. The 0 value of correlation indicates no relationship between two variables.

The Pearson correlation between board size and ROE was 0.003. This value indicated that these two variables have a low positive correlation. Thus, the size of the board was proportional to the firm's ROE. The large board size would result in a higher ROE. The significance value of (*p = 0.985)* was greater than 0.05, this means, the value was statistical insignificance. The correlation between board size and ROA was - 0.144. This negative value notified that these two variables have a weak negative correlation. Therefore, the board size was inversely proportional to ROA. The large board size will cause the lower firm's ROA. The significance value of (*p =0.317)* was more than 0.05, this means, the value was statistically insignificant.

The correlation coefficient value of ROE *(0.003)* and ROA *(-0.144)* indicated that there is a weak positive and negative correlation between board size. The positive correlation indicated that a larger board size will cause a higher firm's ROE. This finding was consistent with Poudel & Hovey (2013) who indicated that large boards led to better financial performance. Previous research conducted by Jensen (1983) suggested that a board should have a maximum of seven or eight members to function effectively in a firm. On the other side, the negative correlation indicated that larger board size will cause inversely proportional to the firm's ROA. This finding result was consistent Jensen M. C (1993), Staikouras, & Agoraki (2007), Adnan, Htay, Rashid, & Meera (2011), Ranti (2011), Alabdullah, Yahya, & Ramayah (2014) found that smaller boards bring better performance in a firm. According to Jensen (1986) said that smaller boards enhance communication, cohesiveness, and coordination with board members in a firm.

The correlation coefficient between board gender diversity and ROE was - *0.044.* This indicated that these two variables have a weak negative correlation. Thus, the board gender diversity was inversely proportional to the firm's ROE. The higher number of female directors on the board will perform the lower firm's ROE. The significance value of (*P= 0.760)* was more than *0.05.* So, the value was statistically insignificant. Likewise, the correlation between board gender diversity and ROA was *-0.040.* Board gender diversity with ROA has also a weak negative correlation. So, it is also inversely proportional to the firm's ROA and a higher number of female directors on the board will perform the lower firm's ROA. The significance value of (*P= 0.784)* was more than *0.05.* So, the value was statistically insignificant. The findings results indicated that there are negative relationships between board gender diversity with the firm's financial performance. The significance value of the firm's ROE (*P= 0.760*) and ROA (*P= 0.784)* was also statistically insignificant.

VIII. CONCLUSION

This study concluded that there were two independent variables (board size and board gender diversity) and dependent variables (ROE and ROA) were used to examine the relationship between the corporate governance framework and the financial performance of banks. The first objective is to identify the corporate governance framework and financial performance and the second objective is to investigate the relationship between board sizes, board gender diversity with the financial performance of Nepalese banking sectors. The first objective's findings revealed that the total number of directors on a board is 7 (approx.) and board gender diversity is 1 female director (approx.) in a company. The results of the second objective revealed a

mixed relationship between board size with ROE and ROA and a negative relationship between board gender diversity and banks' financial performance.

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