



## Do Board Independence Carry Value? A Case Study of Pakistani Banks

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### Abstract

*This study examines the influence of board independence on banking performance of Pakistan over the period of 2007 to 2011. This particular study is conducted by employing publically available data from the websites of Karachi stock exchange and Central bank of Pakistan. Descriptive statistics, correlation and regression analysis are used as most appropriate techniques to find out the results. Outcomes of study revealed a positive impact of board size and independent board members on return on assets and earnings per share. On the basis of outcomes it is suggested that banks with independent boards will perform better than banks having dependent boards.*

**Keywords:** Board Size, Independent Directors, Return on Assets and Earnings per Share.

### Introduction

Banking is a well-known business all over the world. Banks play a vital role in the economy of every country. So banking sector has an important role in economy of Pakistan. In beginning, Pakistan does not have aggressive banking system. Now Pakistani banking sector has strong background in the banking history. State bank of Pakistan is back bone of banking sector of country because all banking functions such as monitoring, operating and controlling activities of all commercial banks are controlled by the central bank of Pakistan. Other important functions like discount rate and minimum reserve maintained by all commercial banks also set by the central bank. Central bank also holds reserves and lends money to commercial banks and government as they needed.

The period of Zulfiqar Ali Bhutto badly affected the banking sectors in Pakistan because in this period all commercial banks were nationalize. After nationalization their performance was badly affected and Pakistani currency devalues and balance of payment was adversely affected. The economic condition of Pakistan severely affected day by day, due to internal and external factors. Pakistani government is unable to control this situation. Today, the banking sector is a highly reputed industry of country, because they provide services to general public in an efficient manner.

Butt reported that shareholders are owners of the organization, corporate governance works for the best interest of shareholders, investors, customers, suppliers and all other stakeholders. Good corporate governance helps to improve the poor image and reputation of the organization and point out the fraud and failure of the organization. Boards of directors are elected by the shareholders and shareholders are owners of the organization. Boards of directors are the important part of any organization. Companies with effective corporate governance structure always select a strong board of directors<sup>1</sup>.

Choi, Park and Yoo suggested that outside directors has significant impact on firm performance. Impact of the board of directors depends upon the nature of the firm. Independence of board has no impact on firm performance, but there is a significant impact of board size on firm performance<sup>2</sup>. Adams and Mehran Said that good corporate governance has unique feature for bank governance<sup>3</sup>. Khan and Hussain investigates that independent directors are an important part of all organization because they have positive impact on firm performance. All firms which have independent directors can improve their performance. Banking sector plays a vital role in economic growth of Pakistan. Banking sector require more attractive policies to enhance the operational and financial performance of banks to increase the growth rate of banks and economy<sup>4</sup>.

**Aim of the Study:** Purpose of current study is to examine the association among firm performance behavior and independent board of directors. The goal of analysis is to find whether or not, independence of board has any impact on performance.

**Objectives of the Study:** This study is specifically conducted to achieve the following objectives: i. To evaluate the extent to which board size affects performance of banking sector. ii. To examine the connection between percentage of outside directors and banking. iii. Performance in Pakistan. iv. To assess the impact of board independence on performance of Pakistani banks and v. To study the interdependence of bank size and financial performance of banks.

**Literature Review:** Kutubi has analyzed the effects of corporate governance practices on firm performance. According to study outside directors and size of board have affected banking performance. There is a sound relationship between board size and performance of Bangladeshi banks. Specifically board independence and performance are positively correlated.

This study indicates that bank size and independent board of directors affect the banking performance<sup>5</sup>.

Bhagat and black found that boards with more independent directors can cause low profitability to the firm but unable to provide evidence that boards with less independent directors increase the profitability of firm. Their findings do not support that a large number of independent board of directors improves profitability of firm, but they agree that a high degree of board independence can improve firm performance<sup>6</sup>.

Rashid, Zoysa, Lodh and Rudkin investigated the impact of board governance in form of description with independent directors on firm economic performance in Bangladesh. In this paper two types of hypotheses are generated to elaborate the relationship between board compositions membership including independent directors and firm performance. According to the researcher of this paper outside independent board of director plays a vital role rather than increase in economic value. So, it was easy to understand that independent outside directors provided effective contribution to firm performance<sup>7</sup>.

The study of Duchin, Matsusaka and Ozbas showed that effect of independent directors on organizational financial well being depends on their cost of hiring. In this paper, they investigate that outside directors are effective when the hiring cost are low and they are ineffective when the acquiring cost is high<sup>8</sup>.

Research of Koerniadi and Tourani studied the effect of independent board on firm performance. They suggested that the independent director does not add anything to firm value but they negatively affects the firm value. The independent directors only effect in positive way to firm value when they are in minority. It is not necessary to increase the number of independent directors in corporate governance because board independence is not suitable for the firms where the manager of firm working as an active partner<sup>9</sup>.

The study of Gani and Jermias examined the effect of board independence on firm performance by using different strategies. Independent board has positive impact on firm performance by using these strategies. These strategies are moderated regression model, strategy of cost efficiency, strategy of innovation and competitive strategy. These strategies provided the better understanding of relationship between the board independence and firm performance<sup>10</sup>.

Egwuonwu studied the effect of independent directors on firm performance. The study found that environment effect mostly because most of the studies conducted abroad such as US, so each continent have different customs, traditions and also have different culture and environments. Independent board of directors has negative impact on firm performance in US, as well as positive impact on firm performance in others countries. It was important to know about actual result that independent

directors only generated the good corporate governance of the firm but did not add to value<sup>11</sup>.

Ararat, Orbay and Yurtoglu investigated that the effect of independent board of directors on controlled firm in turkey. In this paper most of the independent directors were appointed by ex-politicians, ex-bureaucrats and ex-military officers. No strong results were found regarding influence of board independence on performance<sup>12</sup>.

The paper by Mishra, Harsha, Anand and Dhrruva has analyzed the soundness of Indian banking by industry by using CAMEL method. Findings of study revealed that in terms of soundness private banks were on the top of list<sup>13</sup>.

Uadiale proposed that performance of Nigerian firms was affected by the presence of independent directors on board. Findings of study suggested the large board size and independent directors have a strong positive effect on performance of Nigerian firms<sup>14</sup>.

Arosa, Iturralde and Masada conducted a study to test the relationship between independent directors and performance of Spanish non listed family firms. Their findings suggested a positive association among independent directors and firm performance<sup>15</sup>.

Ponnu and Karthigeyan studied that impact of board independence on Performance of Malaysian Public Listed Companies. ROA and ROE used as dependent variables. Proportion of independent directors (NED) was taken as independent variable. They found that there is no significant evidence that relationship between board independence and company performance is of positive nature<sup>16</sup>.

In another research Mishra, Gadhia, Kar, Ptra and Anand utilized Data Envelopment (DAE) and Camel approaches to find out which sector is more efficient and sound in Indian banking industry (private or public)? In accordance with Camel model private sector banks were on the top of list in terms of soundness. DAE outcomes have provided evidence on efficiency that many public and private banks in some previous years have performed poorly and some private banks are performing consistently<sup>17</sup>.

## Research Methodology

**Data Collection:** This study attempts to investigate the impact of board independence on performance of Pakistani banks. A time period of 05 years from 2007-2011 is used for this empirical analysis. Data for banking companies is taken from the website of banks and rechecked from website of Karachi stock exchange. To include in sample, only those banks are selected which remained operational for the whole study period. It is also considered that neither firm should be de-listed by KSE nor it should be in process of merger and acquisition

during the span of study. Firms are also excluded from population where complete financial data was not available in any one of the study years.

**Population:** Population consist of 38 commercial banks which were listed at State Bank of Pakistan at the end of 2011

**Sample:** Out of 38 commercial banks 30 commercial banks are selected as sample by researchers for the purpose of this study due to non availability of data or incomplete financial data.

**Dependent variables:** Two dependent variables are used in this paper. Bank performance is measured by calculating Return on Asset and Earning per share.

**Return on Assets:** ROA measure how efficiently a bank is using its assets to produce return. For the purpose of this study it is calculate by following formula.

$$\text{Return on Assets} = \frac{\text{Net profit after tax} * 100}{\text{Total Assets}}$$

**Earnings per Share:** EPS reflect the profit earned by each share after deduction of tax. It is measured as written below.

$$\text{Earnings per Share} = \frac{\text{Net profit after tax} * 100}{\text{Total outstanding shares}}$$

**Independent variables:Board Size:** Board size represents the sum of persons on board of each bank acting as director.

**Independent Board of Directors:** Independent board of directors is proportion of outside directors on the board of respective bank. Independence of board means that how much board is independent about its decision making and also about the governance of company. Independent directors are not from the shareholders. They are independent from management of company.

**Control Variables: Bank Size:** Bank size is used to describe the business structure of bank in baking industry. Bank size is measured by taking natural log of total asset of the bank.

**Firm Age:** Firm age is the time period in term of number years from which a firm is operating, starting from the day of incorporation.

**Research Hypotheses:**  $H_0$ : There is not any relationship between independent directors and firm performance.

$H_1$ : There is a relationship between independent directors and firm performance.

**Empirical Models:**  $ROA = \beta_0 + \beta_1 BOD + \beta_2 INBOD + \beta_3 FA + \beta_4 BS$   
 $EPS = \beta_0 + \beta_1 BOD + \beta_2 INBOD + \beta_3 FA + \beta_4 BS$

Where: ROA = Return On Assets, EPS = Earnings per Share, BOD = Board of Directors, INBOD = Independent Board of Directors, BS=Bank Size, FA=Firm Age.

## Results and Discussion

**Descriptive Statistics:** Table-1 is used to elaborate the results of descriptive analysis of sample of 30 commercial banks. Table of descriptive statistics represent the 5 years summary of Mean, Median and Standard Deviation of dependent, control and independent variables of banking industry calculated from 2007 to 2011. FS and INBOD are not included in descriptive statistics because; they are taken as natural log of total assets and number of outside or independent directors.

**Table-1**  
**Descriptive Analysis**

	ROA	EPS	BOD	FA
Mean	0.785667	0.866833	9.5	28.5
Median	1.215001	0.170013	8.5	19
SD	1.729663	3.430703	2.12	23.18
N	150	150	150	150

**Correlation Matrix:** Table-2 shows the correlation matrix of the variables related to study. Correlation shows the degree to which variables have tendency to vary together. Correlation is said to be positive when values move in same direction but when they move in opposite direction correlation is negative. BOD is positively associated with all other measures namely BS, FA and INBOD. BS features a positive association with FA and INBOD. FA and INBOD are positively correlated with each other.

**Table-2**  
**Correlation Matrix**

	BOD	BS	FA	INBOD
<b>BOD</b>	1	00	00	00
<b>BS</b>	0.071001	1	00	00
<b>FA</b>	0.174195	0.823338	1	00
<b>INBOD</b>	0.071734	0.156586	0.085243	1

**Regression Analysis:** Table-3 and table-4 exhibits the regression results for ROA and EPS. First column shows the coefficient of independent variables and second column represent the T-statistics. F-statistics shows the overall significance of model. R-square shows that how much percentage change will occur in dependent variable by 1 percent change in independent variable. It shows that how much dependent variable is explained by independent variables. There is a positive significant relationship between ROA and all other variables except FA which is having a positive but insignificant association upon ROA. R square and F- statistic of this model are 42.8% and 10.32. This means that if there is 100% change in independent and control variables then 42.8% change will occur in ROA. According to outcomes of Regression model EPS have a strong favorable relationship with all measures namely BOD, FA and INBOD but have a weak negative relationship with BS. Value of R square is 69.58% which means sample defines the dependent variables up to 69.58%. F statistic for EPS is 31.4637.

**Table-3**  
**(ROA) Regression Results**

Variables	Coefficients	t-statistics
Constant	0.556401	4.33397
BOD	0.203951	2.388444*
FA	0.180776	0.798788
BS	0.031813	2.320225*
INBOD	0.154727	4.961253*

Regression Statistics	
R. Square	0.428789
F-statistics	10.32168
*Significant at level of 5%	5% level

**Table-4 (EPS)**  
**Regression Results**

Variables	Coefficients	t-statistics
Constant	0.189584	0.554546
BOD	0.140362	2.254373*
FA	0.037631	6.781854*
BS	-0.00335	-1.18746
INBOD	0.068795	3.111127*

Regression Statistics	
R. Square	0.695889
F-statistics	31.4637
*Significant at level of 5%	5% level

## Conclusion

According to outcomes of analysis researchers are able to suggest that presence of independent directors on board enhance the financial performance (ROA and EPS) of banks listed at Karachi stock exchange. It means listed banks of Pakistan having independent boards will outperform the banks with dependent boards.

As Hypothesis  $H_1$  was that there is a link between board independence and bank's financial performance. Now results of study has revealed that companies having independent directors will get more return on assets and earnings per share, finally that particular bank will show better performance as compare to banks comprising of non independent boards. So, hypothesis  $H_1$  is accepted and  $H_0$  is rejected because there is a positive association among board independence and performance of listed banks within Pakistan.

In nutshell it is suggested for obtaining the desired objective of increased performance organizations should make sure place of independent directors in their board. For achieving success at corporate level board independence is a mandatory thing. That's why this important point must be kept in mind by companies for achieving higher financial performance.

**Recommendations:** Further research may be carried out by include the more variables of corporate governance such as board composition, number of female directors, CEO duality and family ownership. Same research can be conducted at global level by including all banks operating around the world to increase the validity of study.

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