

Corporate Governance Practices in Listed Banks-Impact on Risk Management and Resulting Financial Performance*

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Abstract: This research aims to analyze the relation between the quality of corporate governance practices and the financial performance of international listed banks. In order to meet this goal the variables related to company returns—IL/GL; NL/TA; ROA; ROE and Tier 1—were associated with the following standards of corporate governance: independence of the board of directors (INDBD); independence of the president of the board of directors (INDPR); size of the board of directors (SZBD); voting power concentration (VPC) and the company's shareholder independence indicator (BvDep). For the composition of the sample we selected listed banks in several European, American, and Japanese stock markets from the period between 2006 and 2009. Results show a significant relation between best corporate governance practices and financial performance of studied banks. This research confirms results attained in previous works but also provides evidence on previously unexplored relations namely between BvDep and IL/GL and NL/TA variables.

Key words: corporate governance; risk management; financial performance

JEL codes: G21, G32, G34

1. Introduction

According to Hawley and Williams (1996) thorough review of literature on corporate governance this concept is related with the form of governance of an organization making sure that its internal and external processes are efficient and acceptable.

Jensen and Meckling (1976) work is considered to be the starting point of modern literature on the subject of corporate governance after seminal propositions from Berle and Means (1932), and classical Adam Smith.

Corporate governance practices must consider cultural and institutional variety across countries and the need to recognize different models of organization and control accordingly (Charkham, 1994).

Implementation of “best practices of corporate governance” aiming the improvement of firm performance and thereby to ensure that financial gains are reasonably shared by everyone involved (OECD, 2004) seems to be

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the key challenge in this field and a major societal concern in the western world.

Recent world financial crisis stressed the importance of having proper corporate governance practices in place especially in banks and other financial institutions. Because banks have an incomparable higher impact in the economy than regular companies even when they are very big there is no doubt that research on banking corporate governance is increasingly relevant and urgent.

Based on this premise we conducted a research to enhance understanding on the influence of corporate governance practices in bank risk management and resulting financial performance. We chose to compare the situation of Portuguese banks with relevant international benchmarks because (1) there is a lack of research including Portuguese financial institutions in corporate governance studies, and (2) in the broad field of corporate governance in general.

2. Corporate Governance and Company Performance

Ever since the fundamental differences between corporate governance models were recognized efforts have been made to identify the most effective one (Denis & McConnell, 2003). The eighties were a period of strong development for Japanese and German economies. Bank-centered corporate governance was considered the most favorable model because it was related to a reduced cost of capital for companies (Becht et al., 2003). In the recession period of Japanese economy during the nineties collusion between Japanese banks and company managers was exposed. Consequently market-centered model was deemed more recommendable. MacAvoy and Millstein's (2003) study shows evidence that companies with best corporate governance systems (with active and independent boards) are more profitable (as measured by the EVA) when compared to companies that according to best practice codes play under inferior corporate governance systems. Common sense suggests that companies implementing corporate governance "Best Practices Codes" have better management (Fama, 2003). A single corporate governance model which can be applied to all companies does not exist (Larcker et al., 2004), and even in countries where capital markets are more sophisticated there is no agreement about the nature and scope that corporate governance tools should have (Shleifer & Vishny, 1997; Bradley, 1999). There are several studies analyzing how the mechanisms of corporate governance and performance interact (e.g., Bhagat et al., 2003; Denis & McConnell, 2003). The relation between ownership concentration and financial performance was firstly approached by Berle and Means (1932). They suggested that due to separation between ownership and control in large American corporations there was an inverse relation between diluted ownership and performance. Some decades later the relation between ownership structure and performance was formalized through the development of theoretical models by Jensen and Meckling (1976) and Stulz (1988). In both cases the authors argued that structure of capital stock impacts performance. First empirical studies on this subject assessed the impact of ownership concentration on performance through the use of linear regressions with ownership structure as independent variable. Among these studies those by Morck et al. (1998), McConnell and Servaes (1990) and Hermalin and Weisback (1991) stand out. These authors found a statistically significant relation between ownership structure and performance which is consistent with the theoretical propositions formulated by Jensen and Meckling (1976) and Stulz (1988). More recent studies made use of sophisticated econometric techniques and considered the ownership structure variable as endogenous rather than exogenous. These studies have not corroborated the idea that ownership structure is an exogenous variable and that it impacts performance. Cho (1998) analyzed the relation between ownership structure, investment, and corporate value in the United States.

Initial results suggest that ownership concentration has a statistically significant impact on corporate investment. Subsequently the author changed the method and concluded that the relations occur in the opposite direction. Specifically Cho (1998) concludes that investments impact corporate value and corporate value, in its turn, impacts ownership structure. Thus the author presents empirical evidence showing that ownership structure is not an exogenous variable. Himmelberg et al. (1999) analyze the determinants of ownership concentration at organizational level and the relation between ownership structure and performance in the US. The study follows the methodology proposed by Demsetz and Lehn (1985) and tries to find evidence that ownership concentration is exogenously determined by other corporate variables such as company size. The authors introduced other variables leading to ownership concentration such as capital intensity, R&D expenses, free cash flow, and investment rate. The most important conclusion of the study is that management ownership concentration and organizational performance are exogenously determined by some characteristics of the legal environment which are only partially observable. Finally after control of observable and unobservable corporate characteristics that do not vary in the time period under analysis the authors concluded that ownership structure does not impact organizational performance. Demsetz and Villalonga (2001) investigated the relation between ownership structure and performance. The initial results pointed towards a significant impact on performance as the results of previous studies such as Mork et al. (1998) and McConnel and Sevaes (1990). Then the authors ran new tests using simultaneous equation systems and the results indicated an absence of significant statistical influence of ownership structure on performance. According to Demsetz and Villalonga (2001) these results corroborate the hypothesis that ownership structure is an endogenous variable with no significant impact on corporate performance. The authors also argue that those results are consistent with the hypothesis that ownership structure is chosen as a way of maximizing corporate performance and that the existence of an ownership structure where capital is more diluted could lead to a higher level of corporate performance despite aggravating agency problems. The presence of controlling shareholders can have positive or negative effects on corporate performance. The main positive effect is the incentive effect described by Claessens et al. (2002). It occurs because controlling shareholders have higher incentives to collect information and monitor managers. This hypothesis is based *ceteris paribus* in the assumption that the larger the share of the controlling shareholder in the company's capital the greater his interest in increasing corporate value. According to Shleifer and Vishny (1997) large shareholders can theoretically bypass the agency problem because they possess both a general interest in maximizing corporate value and enough power to have their interests respected. The authors developed a model in which the presence of large shareholders provides a partial solution to the problems of management monitoring enabling corporate value increase through organizational policy change. The negative effect of large shareholder concentration is the cost for the company. The main negative effect is known as "entrenchment" and it occurs when large shareholders pursue personal benefits at the other investors' expenses. According to Bebchuk (1999) private benefits of control consist in controlling shareholders by using their rights of control (voting rights) to personal benefit. This provides "controllers" an extra gain beyond what would be proportional to their shareholding. Demsetz and Lehn (1985) present another type of cost related to this topic. Shareholders with substantial capital investment will tend to minimize risk exposure through corporate diversification or by adopting a conservative investment policy. In general the potential costs brought by large controlling shareholders are both the direct expropriation of other shareholders and the expropriation by inefficiency resulting from the pursuit of personal interests which do not maximize corporate value. Claessens et al. (2002) analyzed the separation between control rights and rights over cash flow (reserved to shareholders) with the purpose of examining the incentive effect and the entrenchment

effect associated to large shareholders. Conclusions are consistent with the hypothesis of incentive effect and entrenchment effect. Fuerst and Kang (2000) carried out a test to evaluate if the presence of large shareholders (majority shareholders) promotes bigger wealth creation (measured by share price) reflected by an improved performance. Results led to the conclusion that large shareholders have a positive impact on corporate performance despite provoking an adverse effect on share prices.

3. Corporate Governance in Financial Institutions

Levine (2005) considers that bank operations directly impact companies' activities and consequently countries' economic growth. Thus corporate governance is relevant to financial institutions. On one hand because of the important part they play in the economy, and on the other hand because of the systemic impact of possible management failures (BCBS, 1999; 2004). According to Macey and Miller (1988) banks can enter into bankruptcy due to three causes: Fraud and self-interest pursuance (loyalty issues/accountability), insufficient asset diversification, and economic cycle fluctuations. Diamond and Dybvig (1983) had yet mentioned another important cause of bankruptcy—bank runs. Adequate corporate governance practices with good risk management addressing bankruptcy causes contributes to bankruptcy probability reduction. To mitigate the agency problems occurring in financial institutions there has been a development of recommendations, legislation, and standards related to “corporate governance principles”. These principles show a concern with correct bank risk management—one of the strongest corporate governance mechanisms to banks—particularly to credit risk, market risk, liquidity risk, and operational risk. Thus to ensure proper implementation of risk management and monitor banks, the Basel Agreement I was adopted to which followed Basel Agreement II. Both stipulated and harmonized risk management practices according to principles and rules to minimize the occurrence and lower the gravity of risks.

4. Hypothesis and Theoretical Model

Hypothesis 1: There are statistically significant differences in financial performance ratios (evaluated by IL/GL; NL/TA; ROA; ROE; Tier 1) according to VPC.

Hypothesis 2: There are statistically significant differences in financial performance ratios (evaluated by IL/GL; NL/TA; ROA; ROE; Tier 1) according to SZBD.

Hypothesis 3: There are statistically significant differences in financial performance ratios (evaluated by IL/GL; NL/TA; ROA; ROE; Tier 1) according to INDBD.

Hypothesis 4: There are statistically significant differences in financial performance ratios (evaluated by IL/GL; NL/TA; ROA; ROE; Tier 1) according to INDPR.

Hypothesis 5: There are statistically significant differences in financial performance ratios (evaluated by IL/GL; NL/TA; ROA; ROE; Tier 1) according to BvDep.

Hypothesis 6: SZBD, INDBD, INDPR, VPC and BvDep are good predictors of IL/GL.

Hypothesis 7: SZBD, INDBD, INDPR, VPC and BvDep are good predictors of NT/TA.

Hypothesis 8: SZBD, INDBD, INDPR, VPC and BvDep are good predictors of Tier 1.

Hypothesis 9: SZBD, INDBD, INDPR, VPC and BvDep are good predictors of ROA.

Hypothesis 10: SZBD, INDBD, INDPR, VPC and BvDep are good predictors of ROE.

Financial performance was evaluated through the analysis of indicators IL/GL (Interest Loans/Gross Loans), ROA (Return on Assets), ROE (Return on Equity), Tier 1 Ratio, and NL/TA (Net Loans/Total Assets). Proxies

were created to measure compliance with corporate governance “best practices” of sample banks through observation of adopted government model. Corporate governance variables used are INDBD (Independence of the Board of Directors), INDPR (Independence of the President of the Board of Directors), SZBD (Size of the Board of Directors), VPC (Voting Power Concentration), and BvDep (Company’s Shareholders Independence Indicator). Corporate governance is associated to the development of better organizational structures and to the pursuance of enhanced dynamics in its development. This should lead to corporate efficiency increase, risk reduction and control, and consequently an improved financial performance.

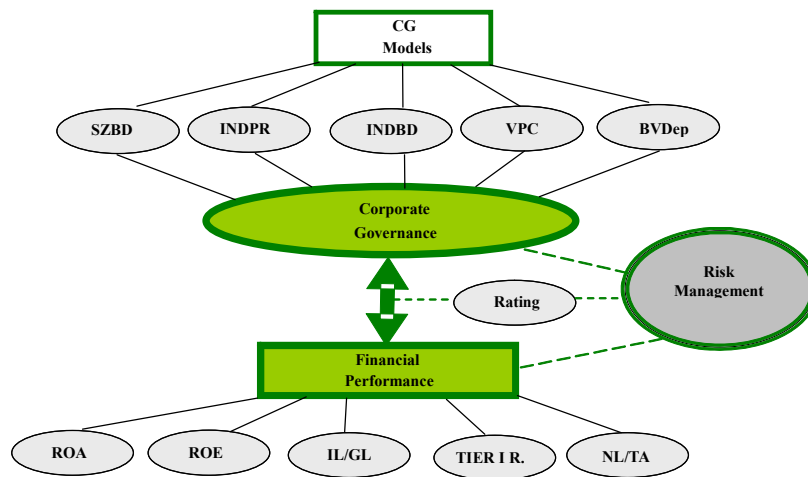


Figure 1 Research Conceptual Model
Source: Authors

5. Method, Sample, and Variables

Using Bankscope (2007) data and annual financial reports from 64 listed banks of 14 different countries we constructed a convenience sample (detailed in Table 1) that was studied for the period 2006 to 2009.

Table 1 Sample Characterization (Source: Authors)

Sample Characterization			
N	Nationalities	Stock Exchange	Indexes
64 Banks	German English American Portuguese French Spanish Italian Japanese Dutch Swiss Belgian Luxemburg Morrocan Swedish	Bolsa de Madrid London Stock Exchange Borsa Italiana Euronext Lisbon Euronext Amsterdam Euronext Paris Euronext Brussels New York Stock Exchange Tokyo Stock Exchange Frankfurt Stock Exchange	DAX Dow Jones Euronext 100 FTSE IBEX Nikkei NYSE PSI 20

IL/GL, Tier 1, ROA, ROE, and NL/TA are the dependent variables, as described in Table 2:

Table 2 Dependent Variables (Source: Authors)

Dependent Variables (Financial Performance)	Variable	Abbreviation	Description
	Impaired Loans/Gross Loans	IL/GL	Indicates the percentage of Impaired loans in relation to total amount of loans
	Tier 1 Ratio	Tier 1 Ratio	Tier One Ratio is Bank's core equity capital to its total risk-weighted assets covered by its Tier One Capital
	Return on Assets	ROA	An indicator of how profitable a company is relative to total assets
	Return on Equities	ROE	The amount of net income returned by shareholder equity
	Net Loans/Total Assets	NL/TA	Measures the percentage of total assets invested in the loan portfolio

Independent variables explanation is the object of Table 3. Table 4 summarizes the expected results of the studied variables (independent and dependent).

Table 3 Research Independent Variables (Source: Authors)

Independent variables (Corporate Governance)	Variable	Abbreviation	Description
	Size of the Board of Directors	SZBD	Indicates total members that compose the Board of Directors (Executive and Non-executive N# of Members BD)
	Independence of the President of the Board of Directors	INDPR	Dichotomous variable assuming value = 1 when the President of the Board of Directors and the President of the Executive Committee are different and value = 0 when they are the same person
	Independence of the Board of Directors	INDBD	Measures the degree of independence of the Board of Directors. It is expressed by the fraction of the total of independent members minus the fraction of executive members of the Board of Directors (INDBD = INDEP/SZBD-EXEC/SZDB)
	Voting Power Concentration	VPC	Measures the degree of voting power concentration under control of the three major shareholders $VPC = \sum_{i=1}^3 (P_i^2 / P)$
	Independence Indicator	BvDEP	Measures an organization's degree of independence in relation to its shareholder structure (A+/B+/A/B/C/D/A-/B-/U)

Table 4 Expected Results from the Studied Variables (Source: Authors)

Independent Variables Corporate Governance (CG)				Dependent Variables Financial Performance (FP)			
SZBD	↓	→	Better CG	IL/GL	↓	→	Better FP
	↑	→	Worse CG		↑	→	Worse FP
INDPR	1	→	Better CG	Tier I Ratio	↓	→	Worse FP
	0	→	Worse CG		↑	→	Better FP
INDBD	↓	→	Worse CG	ROA	↓	→	Worse FP
	↑	→	Better CG		↑	→	Better FP
VPC	↓	→	Better CG	ROE	↓	→	Worse FP
	↑	→	Worse CG		↑	→	Better FP
BvDep	↓	→	Worse CG	NL/TA	↓	→	Better FP
	↑	→	Better CG		↑	→	Worse FP

6. Results

SZBD mean is 15.50 with a standard deviation of 5.22. The number of members in the board of directors was of 13 and 15 elements in 2006, 13 and 14 elements in 2007, 14 elements in 2008, and 14, 15, and 18 elements in 2009. For the study of the dichotomous variable INDPR we conducted frequency analysis and found that in all

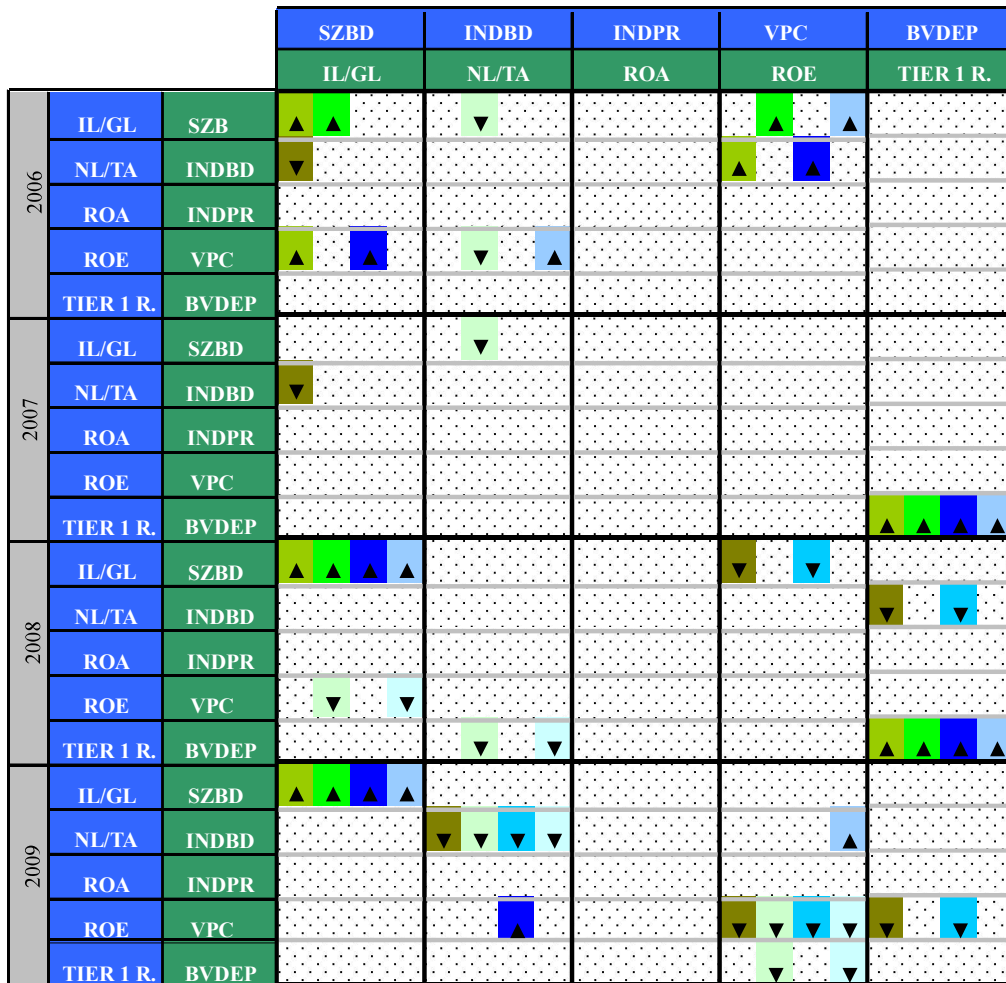
years studied the percentage of boards of directors in which presidents did not perform executive activities was always superior ($> 80\%$) than the corresponding percentage of boards in which the president performed executive activities. INDBD mean is 0.495 (SD = .257). VPC mean is .385 (SD = .282). A frequency analysis was conducted using BvDep with the purpose of finding the level of independence of the studied banks in relation to their shareholders. In 2006, the most frequent rating was A+ (34.4%), followed by D rating with 31.3%. In contrast, the less frequent ratings were B (1.6%) and C (1.6%). Similarly to 2006, in 2007 the most frequent ratings were A+ (39.1%) and D (31.3%). The less frequent ratings were also the same as in 2006: B (1.6%), C (1.6%), apart from A (0.0%), which was not registered in any of the studied banks. In 2008 the most frequent ratings were once again A+ (40.6%) and D (31.3%), similarly to years 2006 and 2007. Conversely, the less frequent ratings were A (1.6%), B (1.6%) and C (1.6%). In 2009 the most frequent ratings were once again A+ (40.6%) and D (31.3%), and the less frequent rating was C (1.6%), exclusive of A and B ratings which were not registered in any of the banks. In all the four studied years IL/GL mean was 2.51% (SD = 1.74). In 2006 the Tier 1 minimum value was 4.9% and the maximum was 24.2%. The mean of the aforesaid year was 9.48% (SD = 3.88). In 2007, the minimum value increased to 5.2% and inversely the maximum value decreased to 21.4%. The mean was 8.92% (SD = 3.12). In 2008 there was a new increase in Tier 1 minimum and maximum values to 5.5% and 22.9% respectively. In 2009 this ratio's minimum value decreased to 4.9% and the maximum value increased to 24.4%. Analyzing the four studied years we found that Tier 1 mean is 9.17% (SD = 3.18). For the period 2006 to 2009 we found that ROA mean value was .72 with a standard deviation of .441. The ROE mean value was 10.31 with a standard deviation of 10.51. The NL/TA mean value was 56.09% (SD = 22.04) in the studied years.

Using inferential statistics and Pearson's correlation coefficient it was possible to discover established relations between the several Corporate Governance constructs and financial performance. Later a partial correlation analysis was conducted using rating as the control variable. Figure 2 summarizes the most important correlations found in this research.

In Hypothesis 1, corporate governance variable VPC was related to financial performance. According to the studies of Goyal and Park (2002), a smaller concentration of share capital would lead to an improvement of financial performance. The obtained results regarding the relation between VPC and IL/GL (year of 2006), VPC and ROE, and VPC and Tier 1 Ratio (year of 2009), confirm the hypothesis that "good practices" of corporate governance measured by VPC have an influence on financial performance improvement (a better corporate governance leads to a reduction of impaired loans) as well as from higher values of capital profitability (ROE) and solvency (Tier 1 Ratio).

In Hypothesis 2, corporate governance variable SZBD was related to financial performance. With the exception of year 2007 the IL/GL ratio was always negatively correlated to SZBD which is consistent with what we intended to demonstrate. That is, better corporate governance—with a board of directors formed by an adequate number of members—leads to better loan management. This results in a decrease of impaired loans which leads to an improved financial performance.

In Hypothesis 3, it was expected to find that a board with a higher number of independent members would be associated with better financial performance. The obtained results are coincident with the investigations of Baysinger and Butler (1985), Hermalin and Weisbach (1991), Lawrence and Stapledon (1999), and Bhagat and Black (2002), who obtained statistically non-significant relations between board constitution and company performance.



Legend

- ▲ Positive Correlation between CG and FP variables
- ▼ Negative Correlation between CG and FP variables
- ▲▲ Positive Correlation between CG and FP variables (with control variable)
- ▼▼ Negative Correlation between CG and FP variables (with control variable)
- ▲▲▲ Positive Correlation between CG and FP variables
- ▼▼▼ Negative Correlation between CG and FP variables
- ▲▲▲▲ Positive Correlation between CG and FP variables (with control variable)
- ▼▼▼▼ Negative Correlation between CG and FP variables (with control variable)

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- 1 Correlation between CG and FP
- 2 Correlation between FP and CG
- 3 Correlation between CG and FP (w/ control variable)
- 4 Correlation between FP and CG (w/ control variable)

Figure 2 Negative and Positive Correlations between the Study Variables

In Hypothesis 4, we studied the relation between INDPR and financial performance. In accordance to the investigation conducted by Boyd (1995), the expected result was that boards of directors in which presidents did

not perform executive activities would tend to perform better. No statistically significant relations occurred and this hypothesis was rejected.

Hypothesis 5 introduced BvDep variable. We expected higher independence towards shareholders to lead to better financial performance. This would result from potential agency problems decrease. A positive—strong or moderate—correlation was found between shareholder independence indicator and financial performance through Tier 1 Ratio (financial solvency). Thus, the obtained results confirmed what was expected. The absence of other studies correlating these variables makes it impossible to compare results.

Hypothesis 6, the relation between corporate governance and financial performance measured by IL/GL ratio was investigated. We found evidence of a relation between IL/GL and VPC (year of 2006), SZBD (with the exception of year 2007), and INDBD (years of 2006 and 2007).

Hypothesis 7 focused on the correlation between NL/TA variable and the constructs of financial performance. Only a weak positive correlation was verified between NL/TA and INDBD thus providing no confirmation of an existing relation between corporate governance and financial performance.

The correlations studied in *Hypothesis 8* confirmed the existence of a statistically significant relation between Tier 1 Ratio and INDBD but to the contrary of what was expected. Higher values of this solvency ratio are associated to lower values of board independence. Statistically significant relations between Tier 1 Ratio and shareholder independence indicator were also found but in the direction expected.

Regarding *Hypothesis 9*, no relations were found between the variables that would allow not rejecting this hypothesis. This means that ROA did not exert any statistically significant influence on the corporate governance construct.

Hypothesis 10 regarded the relation between ROE and corporate governance constructs. We found that in 2006 there is a relation between ROE and INDBD variables but to the contrary of what was expected. As for SZBD (year of 2008) and VPC (year of 2009) the obtained results confirm the formulated hypothesis meaning that improved financial performance is obtained by banks with reduced SZBD and weaker VPC. Previous studies such as Black et al. (2004), Klapper and Love (2004), Gompers et al. (2001), and Black et al. (2006) put in evidence statistically significant relations between financial performance—evaluated by ROE—and an effective corporate governance.

In a second phase of this research we introduced control variable Rating (RTG). The main impacts in the obtained results were:

(1) As for the correlations verified between corporate governance and financial performance (Hypotheses 1 to 5), the relations with significance verified prior to introducing the control variable remained generally unchanged when this variable was considered in the study.

(2) As for the correlations existing between financial performance and corporate governance (Hypotheses 5 to 10), the behavior was similar to that of Hypotheses 1 to 5 meaning the obtained results were not generally affected when compared to those obtained without the presence of this control variable.

The purpose of the control variable was to validate conclusions taken from the existing results. Nevertheless, results obtained after control variable introduction are very much like those registered before.

7. Conclusions

There is evidence that the adoption of corporate governance “good practices” generate better financial results

(in terms of reliability and relevance) making them good indicators of future organizational performance and reflecting year after year the intrinsic corporate value (Dechow & Schrand, 2004). This allows market investment analysts to elaborate better forecasts contributing to the accuracy of the predicted results. The adoption of corporate governance “good practices” reduces uncertainty about the organization’s future increasing analysts’ and/or investors’ confidence in the company favoring market liquidity. This research provided evidence that better corporate governance is related to a more favorable rating (and vice versa) as well as to an improved financial performance. In a way, ratings issued to sample banks reflect the previously found relation between corporate governance and financial performance since there was no significant change in the correlation results after control variable introduction. Overall, this study found evidence that corporate governance positively impacts financial performance. Less voting power concentration (VPC) originated better values in IL/GL, ROE, and Tier 1 Ratio. The size of the board of directors (SZBD) was negatively related to IL/GL ratio, which is consistent with the formulated hypothesis. This means that boards of directors composed of an inferior number of members contribute effectively to improve financial performance through a smaller percentage of impaired loans in the universe of loans granted by the investigated companies. Statistically significant correlations were identified between shareholder independence indicator (BvDep) and Tier 1 Ratio. Evidence was found that the higher the organization’s independence regarding shareholders, the higher its financial solvency through higher values of Tier 1 Ratio and consequent financial performance improvement. Tier 1 Ratio was positively related to BvDep with strong or moderate statistical significance which identifies and confirms the risen hypothesis that a better financial performance—higher Tier 1 Ratio—is associated to higher shareholder independence. Better values of financial performance in ROA, IL/GL and Tier 1 Ratio were found when associated with more reduced SZBD, lower VPC, and higher INDPR.

This research included variables that had not yet been included in previous studies such as BvDep and IL/GL from which was possible to determine statistically significant relations. In some cases obtained results indicated that better corporate governance is associated to better financial performance, and that financial performance is obtained in banks that use best corporate governance practices. The control variable (RTG) did not produce any effects altering the evidence found before its introduction. Such result could be associated to the fact that corporate governance incorporates risk management in its own sphere of action, and ratings reflect good or poor risk management which is diluted into what is broadly defined as corporate governance.

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