Does Corporate Governance has Impact on Non-Performing Loan:

A Study on Bangladesh Banking Sector

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Abstract

This study examines the role of corporate governance on non-performing loans (NPLs) of Bangladesh banking sector. Specifically, it investigates to find out whether Board Size, Board Independence, Big 4 affiliated External Auditing, Independent as well as Expert Internal Audit Committee, Political Connection and Female Member Representation in Board of Directors (BOD) can be useful in curtailing the growing NPL in this sector. Data has been collected from the published annual reports of all the 30 listed banks in DSC from 2012-2016. Using multivariate pooled regression analysis, the study reveals that board size, Big 4 affiliated external audit and expert internal audit committee has significant negative influence on NPL of Bangladeshi listed banks. But remaining variables like board independence, independent internal audit committee, political connection and female member representation in BOD has no significant impact on NPLs.

Keywords: Non-performing loans, Board Size, Audit Committee, Big-4, Political Connection, Female Board Member, Bangladesh.

1.0 Introduction

The concept of corporate governance sounds simple and unambiguous, but when one attempt to define it and scan available literature to look for precedence, one comes across a bewildering variety of perceptions behind available definitions (Fernando, A.C., 2012).

However, corporate governance is considered as the most important topic to be discussed by financial entities and economic institutions because of two reasons Firstly, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth (King and Levine, 1993 a & b; Levine, 1997). Secondly, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms (Levine, 2004). However, the practice of corporate governance in financial sector of Bangladesh is not satisfactory. Recent financial scams and increasing default loan size have brought the banking sector of Bangladesh under criticism. One of the perennial problems is the rise of non-performing loan which is defined by International Monetary Fund (IMF) as "A loan is non-performing when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full."

Banking sector plays a vital role in developing countries like Bangladesh which is now transforming from agriculture based economy to industry based economy. In Bangladesh where prudential regulations and supervision is inadequate to provide a safety net for the depositors and stakeholders of the banks, special attention on corporate governance is required on a priority basis (Mahmood and Islam, 2015).

At the moment, the number of scheduled banks operating in Bangladesh stand at 57, all of which are under the purview of the Bangladesh Bank. In the last ten years or so, there has been rapid growth in the banking sector with many new banks operating in the country for the first time. However, the banking sector of Bangladesh has been plagued with a number of disappointing trends for some time. The behavior of non-performing loan in the banking sector has been following a certain trend during the last few years. As of April 2017, the accumulated default loans in the economy is Tk. 111,347 crore including the written off loans totaling nearly Tk. 40,000 crore (Rahman, 2017). Bangladesh Bank data show non-performing loans account for 10.53 percent of the total outstanding loans (Rahman, 2017). But analysts say the figure would have been much higher if loans had not been rescheduled and restructured. Among the South Asian countries, Bangladesh stands second, only after Pakistan in terms of NPL as a share of total loan. Major contributor to the rise in bad loans is state-owned commercial banks (SCBs). Even though only about one fifth of total loans of the banking sector are disbursed by the SCBs, the share of SCBs' NPL in total classified loans was 45.57 percent as of September 2016, according to Bangladesh Bank data. The highest share of loan is provided by private commercial banks (PCBs) which contribute to 42.12 percent of total NPL. The growing NPL have become a major threat for the banking industry as many lenders, particularly those owned by the government, are facing huge capital shortfall because of bad debts. The NPL stood at 8.93 percent in 2013 and soared to 9.23 percent in a space of three years (Daily Star, 2017). The rising NPL is not only rattling the banking sector but also depriving the people of loans at lower rates. It should be noted that, banks do business with depositor's money, if banks can't get depositors fund when they want, there might be a vulnerable situation in the industry. Public may lose confidence from the bank, which may create run on the bank. As a result, profitability of the bank can be negatively affected (Akter and Roy, 2017).

At this situation it has been considered expedient to conduct study for determining the impact of corporate governance variable on non-performing loans. Ahmed et al. (2016), studied to examine the role of corporate governance on the non-performing loans of the banking sector of Pakistan. The study revealed that corporate governance does matter significantly for the non-performing loans of the banks in Pakistan. However, Nyor and Mejabi (2013) used the almost same methodology of Ahmed et al. (2016), with a view to finding out whether these CG variables can be useful in curtailing the incidence of non-performing loans that have bedeviled Nigerian Money Deposit Banks but study found that corporate governance variables have no significant impact on

non-performing loans of Nigerian Deposit Money Banks. In such a situation, this paper is attempted to find out the impact of various CG variables on NPL in the context of Bangladesh.

2.0 Objectives of the Study

The main objective of this study is to examine the impact of corporate governance on non-performing loans in Bangladeshi banking sector. How different variables of corporate governance such as board size, board independence, Big 4 affiliated external auditing firm, independence as well as expertise of internal audit committee, political connection and female member representation in board of directors could influence non-performing loans will be assessed empirically.

3.0 Literature Review and Statement of Hypothesis

The history of corporate governance correspondingly extends back at least to the formation of the East India Company, the Hudson's Bay Company, the Levant Company and the other major chartered companies launched in the 16th and 17th centuries. Corporate governance first came into vogue in the 1970s in the United States. Within 25 years corporate governance had become the subject of debate worldwide by academics, regulators, executives and investors (Cheffins, 2012).

Following the large number of corporate collapses around the world, considerable research on corporate governance is conducted within the developed countries context, such as the United States, the United Kingdom, Australia, Germany and Japan. However corporate governance in emerging economy has not been studied as intensively as in the developed markets (Shleifer and Vishny, 1997; Gibson, 2003; Denis and McConnel, 2003). To date most studies targets developed countries and comparably little known about the corporate governance and its role in banking industry of the developing economies (Ahmed et al., 2016).

Board size is one of the key variables to determine the corporate governance. Agorak et.al (2010) explored the effect of board size and composition on the banking efficiency and concluded that higher the board size less the efficiency of the banks. They took non-performing loans ratio as the measure of the inefficacy. Similarly, Simpson and Gleason (1999); Belkhir (2006) and Altunbas et al., (2001) came with the same conclusion that higher the board size lower the performance of the banking and high non-performing loans. Liang et al., (2013) concluded that board meetings and the proportion of independent directors have significantly positive impacts on both bank performance and asset quality while board size has a significantly negative impact on bank performance. Bussoli et al. (2015) explored board size negatively influences the quality of loans and resulted in higher non-performing loans. The same argument is proved by Farrell and Whidbee (2000). In the light of the above discussion the following hypothesis is stated:

H1: Board Size has Positive influence on NPL in Bangladesh Banking Industry

Empirical findings on the board independence and perform in mixed in the literature. For instance, Hermalin and Weisbach, (1991); Bhagat and Black, (1999); Kiel and Nicholson, (2003); Agrawal and Knoeber, (1996) find no relationship between the board independence and firms performance. Dehaene et al. (2001) empirically proved that firms with the outside directors perform better. Moreover, Skully (2002) suggest more outside directors are good for the banking governance. Byrd & Hickman (1992) concludes that shareholders of firms with independent directors serving on the boards can expect that these directors will maximize managements' behaviors and will distinguish between good and bad decisions made by management. Alves (2014) concluded that independent directors have a tendency for increased monitoring and are therefore expected to insist on better earnings quality. Rashid (2018) stated that in many developed countries, board independence is an important attribute of corporate board practices however board independence still may be an illusion in Bangladesh. Therefore, the following hypothesis has been developed:

H2: Board Independence has Negative influence on NPL in Bangladesh Banking Industry

External audit plays an important role in reducing information asymmetry and mitigating agency problems as well as assures all users of accounting information about the quality, accuracy and reliability of information in financial reports (Jensen and Meckling, 1976; Willenborg, 1999). Therefore, the external independent audit plays a crucial role for strong corporate governance (Watts and Zimmerman, 1986).

Karaibrahimoğlu (2013) showed firms' auditor choice in terms of Big-4 and audit firm industry specialization is affected by the firm-level corporate governance mechanisms of firms and finds that external independent audit is an important component of strong corporate governance. Hoque et al. (2015) examines whether firms' auditor choice reflects the strength of corporate ethics. Based on a sample of 132,853 firms the study finds that firms in countries where "high corporate ethical values" prevail are more likely to hire Big-4 auditors.

Lin and Liu (2009) explored that firms with weaker internal corporate governance mechanism are inclined to choose a low-quality auditor. On the other hand, with improvement of corporate governance, firms should be more likely to appoint high-quality auditors. Form the above discussion following hypothesis is stated:

H3: Belonging External Auditor to 'Big 4' has Negative influence on NPL in Bangladesh Banking Industry

Interest in audit committees as part of overall corporate governance has increased dramatically in recent years, with a specific emphasis on member independence, experience, and knowledge (DeZoort et al., 2001). Larry & Taylor (2012) revealed that stronger audit committee independence and competence, but not diligence, are significantly related to a lower incidence and severity of financial restatements. Xie et al. (2003) examined the role of the board of directors, the audit, and the executive committee in preventing earnings management and concluded that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.

The Smith Committee (2003) had recommended four criteria of good audit committee, first, all members of the committee should be independent non-executive director, second, the board should have at least one member with recent and relevant experience, third, the appointments of the AC should be for a period of three years, finally, the renewable period of not more than two additional three-year periods as long as the members continue to be independent.

H4: Independent Internal Audit Committee has Negative influence on NPL in Bangladesh Banking Industry

Beatty (1989); Willenborg (1999) and Jensen & Meckling (1976) advocates that, audit service is perceived to play an important role in reducing information asymmetry as well as in mitigating agency problems. According to Defond and Francis (2005), meeting these two roles depend on audit quality. While audit quality is considered an important element of corporate governance, it is unclear whether audit quality and other aspects of corporate governance are fundamentally complements or substitutes. According to the Notification published on 07 August, 2012 by Bangladesh Securities and Exchange Commission (BSEC) Para 3.1 (iii), All members of the audit committee should be "financially literate" and at least 1 (one) member shall have accounting or related financial management experience.

García-Sánchez et al., (2017) suggested that the presence of financial experts on audit committees is useful to reduce insolvency risk, supporting the monitoring advantage hypothesis of financial expertise.

Iyer et al. (2013) found that accounting knowledge and audit experience are valuable and contribute to less earnings management and better internal control. From the above discussion following hypothesis can be drawn:

H5: Expert Internal Audit Committee has Negative influence on NPL in Bangladesh Banking Industry

Ahmed et al. (2016) explored that during dictator regimes non-performing loans decrease significantly. Brown and Dinc (2005), Dinc (2005) argued that politicians do have influence in the credit market of the banks and use it for their political purpose. In the same line Gomez and Jomo (1997) and Fraser et al. (2006) explained firms with the political connections are highly leveraged due to their connection with the politicians. It is easier for firms with political connections to obtain long-term loans with extended debt maturities (Yang et al., 2014) thus political ties ultimately leads to poor corporate governance (Liedong and Rajwani, 2018). By studying the above literature, following hypothesis has been formulated:

H6: Political Connection in BOD has Positive influence on NPL in Bangladesh Banking Industry

A number of studies point to a positive correlation gender-varied corporate management and financial performance. Gulamhussen and Santa (2015) states, presence and percentage of female directors in boardrooms have a positive influence on performance. García-Meca et al., (2015) concluded

that gender diversity increases bank performance. Shrader et al., (1997); Erhardt et al., (2003); Lindstaedt et al., (2011); Mahadeo et al., (2012) and Balina (2016) conclude that where decision making is dominated by women show better ROA, ROE, ROI, net profit and other measure of performance. However, mere representation of females on corporate boards is not related to firm financial performance if other factors are not considered (Pletzer et al., 2015). From the above discussion following hypothesis can be drawn:

H7: Female Member Representation in BOD has Negative influence on NPL in Bangladesh Banking Industry

4.0 Methodology

4.1 Data Sources

To investigate the hypotheses, data has been gathered from all of the thirty[1] (30) listed banks at Dhaka Stock Exchange (DSE). The study covers a period of five years i.e. 2012-2016. Published annual reports of each listed bank have been collected to gather data and analyzed with the help of EView 10.

4.2 Measurement of Variables

The best determinants of the corporate governance are controversial among researchers. There is no consensus which variables are the best predictors of the governance. Different researchers use different variables, so it is little difficult to determine what variables should be taken to measure the corporate governance. However the following table describes e variables used in this study:

Table 1: Estimation of CG variables and NPL

Variables	Definitions	Measurement
NPL	Non-performing Loans	Percentage of non-performing loans to total loans and advances of each particular year.
BS	Board Size	Number of people on the BOD of a bank.
BI	Board Independence	Proportion of independent director (ID) to total number of directors
BIG4	Big 4 affiliated External Auditor	A dichotomous variable; assigned 1 for the banks whose financial statements are audited by external audit firm affiliated by Big 4 otherwise assigned 0.
IIAC	Independent Internal Audit Committee	A dichotomous variable; assigned 1 for the banks whose internal audit committee contains at least one independent director (ID) otherwise assigned 0.
EIAC	Expert Internal Audit Committee	A dichotomous variable; assigned 1 for the banks whose internal audit committee members, at least one of them, possess relevant accounting and financial knowledge and professional degree in relevant field. Otherwise assigned value is 0.
PC	Political Connection in BOD	Another dichotomous variable; assigned 1 for the banks whose members of the board of directors (BODs) include any member of parliament (MP) or any renowned political figure; otherwise assigned 0.
FE	Female Member Representation in BOD	Number of female members in BOD.

[1] As of September, 2017

4.3 Regression Model

This study uses the following regression to test the above stated hypotheses:

$$NPL = C + \beta_1 BS + \beta_2 BI + \beta_3 BIG4 + \beta_4 IIAC + \beta_5 EIAC + \beta_6 PC + \beta_7 FE + \beta_{3,1} BIG4*BS + \beta_{3,2} BIG4*BI + \beta_{4,2} IIAC*BI + \beta_{5,1} EIAC*BS + \beta_{5,2} EIAC*BI + \varepsilon \quad (1)$$

5.0 Results and Discussion

Table 2: Descriptive Statistics

Variables	Observations	Mean	Std. Dev.	Min.	Max.
NPL	150	7.58	12.41	1.63	77.52
BS	150	14.24	3.87	6	22
BI	150	0.17	0.08	0.00	0.50
BIG4	150	0.27	0.44	0	1
IIAC	150	0.93	0.26	0	1
EIAC	150	0.72	0.45	0	1
PC	150	0.13	0.34	0	1
FE	150	1.39	1.40	0	5

The above posed table reveals descriptive statistics for all the variables used in the study. Starting from the non-performing loan (NPL) it has been observed that average percentage of NPL amounts to 7.58% which means that seven and half percentage of total loans and advances lend by banks become uncollectable. The maximum percentage of NPL amounts to 77.52% of total loans and advantages however the minimum percentage of NPL amounts to 1.63% with standard deviation of 42.41%. Board Size (BS) has mean of 14.24 which refers to the average number of members in BOD of Bangladeshi listed banks. Maximum board size amounts to 22 persons whereas 6 is the minimum value. Descriptive statistics shows that, average

value of overall board independence (BI) amounts to 0.17 which means that on average 17% of the total number of directors in BOD are independent directors. However, empirical study shows that some banks has no independent director (Minimum=0.0) whether some banks has as many as independent director as general shareholder director (Maximum =0.50). The variable denoted by BIG4 representing the affiliation of external auditor of a particular bank to Big 4 firms have a mean of 0.27 with standard deviation of 0.44. The study finds that, independent internal audit committee (IIAC) and expert internal audit committee (EIAC) possess a mean of 0.93 and 0.72 respectively that means 93% of the total sampled internal audit committee is independent and 72% of the total sampled audit committee contains at least one person having relevant financial and accounting knowledge. However, standard deviation of the two variables scores to 0.26 and 0.45 respectively. Political connection on board (PC) has a mean of 0.13 which refers that 13% of the total sampled BOD includes any member of parliament (MP) or any renowned political figure with standard deviation of 0.34. The study finds that, female member representation in board (FE) has a mean of 1.39 means that on average more than one member in BOD is a female member with maximum value scored up to 5 members.

Table 3: Correlation Analysis

	NPL	BS	BI	BIG4	IIAC	EIAC	PC	FE
NPL	1.000							
BS	-.259	1.000						
BI	-.163	-.434	1.000					
BIG4	-.110	-.010	-.077	1.000				
IIAC	.018	-.148	.416	.112	1.000			
EIAC	-.293	-.057	.326	.141	.394	1.000		
PC	-.059	.179	-.173	-.015	-.040	-.105	1.000	
FE	-.029	.053	.078	-.005	-.014	-.040	-.038	1.000

The above table depicts Pearson Correlation among the variables. Starting from board size (BS), it has been found that BS has negative correlation (-0.259) with NPL means higher board size will decrease NPL. However, this result is contrary to the prior expectation of the study. The study finds that, board independence (BI) has negative correlation (-0.163) with NPL means more independent directors in BOD will decrease NPL in Bangladeshi listed banks. The study concludes that Big 4 affiliated external auditing (BIG4) has negative correlation (-0.110) with NPL that means the more Big 4 affiliated external auditing the less is the NPL. Independent internal audit committee (IIAC), however, shows positive correlation (0.018) with NPL meaning audit committee independences increases NPL which is opposite to the prior expectation of the study. Expertise of internal audit committee (EIAC), on the other hand, depicts negative correlation (-0.293) with NPL which meets the prior expectation. Political connection in board (PC) also shows negative correlation (-0.059) with NPL. It means having political figures in BOD reduces NPL as opposed to the previous expectation. Finally, female member representation in board (FE) shows negative correlation (-0.029) with NPL meaning that having female members in board is supposed to decrease the NPL as expected to initial expectation of the study.

The study has been conducted based on prior expectation that corporate governance should have a negative relationship with the level of non-performing loans of Bangladesh banking industry. However, the results received by analyzing data using multiple linear regression are as follows:

Table 4: Pooled Regression Model of CG variables on NPL in Bangladesh

Models	Coefficient	Std. Error	't' Statistics	'p' value
C	82.59	7.75	10.65	0.00
BS	-4.40	0.43	-10.24	0.00
BIG4	-30.32	11.51	-2.63	0.01
IIAC	6.87	4.51	1.52	0.13
EIAC	-74.81	9.08	-8.24	0.00
FE	-0.85	0.55	-1.56	0.12
BIG4*BS	1.36	0.57	2.40	0.02
BIG4*BI	61.10	28.93	2.11	0.04
IIAC*BI	-73.89	23.77	-3.11	0.00
EIAC*BS	4.11	0.51	8.08	0.00
EIAC*BI	53.32	25.28	2.11	0.04

R-squared	0.512395	Mean dependent var.	7.582600
Adjusted R-squared	0.477315	S.D. dependent var.	12.40543
S.E. of regression	8.968743	Akaike info criterion	7.295873
Sum squared resid.	11180.93	Schwarz criterion	7.516653
Log likelihood	-536.1905	Hannan-Quinn criter.	7.385569
F-statistic	14.60668	Durbin-Watson stat.	0.426953
Prob(F-statistic)	0.000000		

Redundant Variables: PC; BI and IIAC*BS	
• F-statistic	0.654074
• Log likelihood ratio	2.148751
• Prob. F(3,136)	0.5817
• Prob. Chi-Square(3)	0.5421

Starting from the board size, it has been observed that Board Size (BS) has significantly negative influence on the non-performing loans (-4.40, 0.00) that is inconsistent with prior expectation of the study and literature like Gleason (1999); Belkhir (2006); Ahmad et al. (2016). Although larger board size has its own merits and demerits in the organization as a whole, in this study it can be concluded that larger board size generates lower NPL in Bangladesh banking industry.

Affiliation of external auditing firm to Big 4 has significant negative influence (-30.32, 0.01) on NPL in Bangladesh confirming prior expectation and other literature. It should be noted that, BIG4 combined with Board Size (BS) as well as Board Independence (BI) both show significant positive influences (1.36, 0.02 and 61.10, 0.04 respectively) on NPL in Bangladesh.

Another variable, EIAC, also shows significant negative influence (-74.81, 0.00) on NPL in Bangladesh and confirms prior literature and expectation. Moreover, EIAC combined with Board Size (BS) as well as Board Independence (BI) both evidence statistically significant positive influences (4.11, 0.00 and 53.32, 0.04 respectively) on non-performing loans.

On the other hand, IIAC, shows positive (6.87) but statistically insignificant (0.13) influence on NPL in Bangladesh which is opposed to prior expectation of the study and other literature like Larry & Taylor (2012). However, IIAC combined with Board Independence (BI) shows a very significant negative influence (-73.89, 0.00) on NPL.

The study concludes that, Board Independence (BI), Political Connection in BOD (PC) and Independent Internal Audit Committee (IIAC) combined with BS don't show any significance influence on NPL. Female member representation in board (FE) shows negative (-0.85) influence on non-performing loans and concludes that FE is not statistically significant to NPL.

The overall model as measured by the F-statistic of 14.61 with probability of 0.00 which is statistically significant indicates that corporate governance in Bangladesh, taking BS, BIG4, IIAC, EIAC and FE has significant impact on NPL of Bangladeshi listed banks. After analyzing all the data it has been found that the value of R^2 is 0.512 means that only 51.2% of the total variation in dependent variable (NPL) is explained by all the independent variables tested. Also, the adjusted R^2 shows 0.477 which is very low compared to other studies like Ahmad et al. (2016).

6.0 Conclusion

The study has been conducted to examine the effect of corporate governance variables as measured by board size, board independence, Big 4 affiliated external auditing, independent internal audit committee, expert internal audit committee, political connection in board and female member representation in board on the raising non-performing loans in Bangladesh. After analyzing the data from 2012-2016 of all of the 30 listed banks in Dhaka Stock Exchange it has been discovered that explanatory variables like board size (BS), Big4 affiliated external auditor (BIG4), expert internal audit committee (EIAC), BIG4 combined with BS and BI, EIAC combined with BS and BI as well as BI combined with IIAC are statistically significant to non-performing loans in Bangladeshi listed banks. However, the results of the analysis suggest that the effects of variables like Board Independence (BI), Independent Internal Audit Committee (IIAC), political connection in board (PC) and female member representation in board (FE) are not statistically significantly to non-performing loans. The possible reason for this inconsistency might be the research methodological differences between this study and other the studies mentioned. However, variables tested in this study only describes 51.2% of the total variation in dependent variable i.e. non-performing loans. The possible reasons for coming up with lower value of R-squared and adjusted R-squared could be many. For example, the activeness of the bank's internal audit committee, procedure followed for granting larger amount of loans, use of indirect political influence for loan sanctioning, use of bribe for granting loans, inadequate collateral, use of same collateral multiple times to get loan, nepotism, not following proper guidelines given by central bank etc. As some of the variables do not have significant impact on percentage of NPL in Bangladesh the study, however, recommends that emphasis should be shifted from these explanatory variables to other

variables, such as bank's accountability, transparency, formation of bank's board as well as its audit committee, principles of lending, proper lending risk analysis, audit effectiveness, compliance with laws and regulation and proper disclosure.

For a developing country like Bangladesh, banks play a key role. Being the largest unit of financial sector, banks must operate at its best with utmost efficiency to contribute in the economic development of the country. Implication of proper corporate governance in banking sector is of greater importance because positive relationship between economic growth and corporate governance is theoretically proved (OECD, 2004). Without proper implication of corporate governance in such an important sector will endanger the present economic growth of the country in long run.

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