


“The effect of Corporate Governance Information (CGI) on banks’ reporting performance”

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THE EFFECT OF CORPORATE GOVERNANCE INFORMATION (CGI) ON BANKS' REPORTING PERFORMANCE

Abstract

Recent literature on Corporate Annual Reports (CAR) underlines that, in order to meet the changing needs of CAR users, more narrative (forward looking) information should be provided, with a focus on those factors that are liable for longer term value of banks financial performance. This paper investigates the Management Commentary portion (MC) and specifically the effect of Corporate Governance Information (CGI) on banks' reporting performance mechanisms such as board structure, audit function, bank size and common equity.

Return on Assets (ROA) ratio is used as a proxy to measure financial performance. The data sample comprises of 86 worldwide banks during the period of deep economic crisis (2008–2011). Novelty of the study is the search for the effect of core characteristics of corporate governance on banks' performance during the financial crisis period. The research uses a Panel Estimated Generalized Least Squares (EGLS) regression model in order to examine the aforementioned effect. The results of this research suggest that boards' independence strongly supports banks' efficiency and operations, as well as external audit contributes positively to banks' efficiency during the crisis period.

Keywords

Corporate Governance Information (CGI), board structure, audit function, Management Commentary portion, economic crisis period

JEL Classification G01, G14, G23, G32, G34, M42

INTRODUCTION

Financial system comprises one of the most important determinants of the national economies worldwide. The adjustments and challenges facing financial institutions have a great impact on a country's economic growth and in the configuration of the economic environment of the markets. A healthy marketplace needs a stable financial system in order to transfer capital from the "surplus economies to the deficit ones" and funds to be invested in the productive process. Without doubt, the banking sector is the focal source of stability and economic growth. A healthy and efficient financial system is crucial for the economic growth of the economy, since it deploys effectively the funds in the economic system.

Throughout the previous 25 years standard-setting bodies, bankers and academics have been discussing and finding ways on how to enhance the informativeness of narrative reporting, e.g., in the form of Management Commentary. The researches in this field have had a varying focus on which types of users Management Commentary (MC) is to be aimed at, and, in turn, perceptions of its possible content have been altered somewhat in composition. Immediately after the end of the last millennium it

seems as if narrative reporting to a rising degree has been focused on meeting the needs of a much broader group of stakeholders than the perception of relevant users applied in earlier studies (Nielsen, 2010). One thing that it seems to be the dominant discourse in the business narrative reporting debate at the present is the well-known to all as Corporate Governance (CG).

“Corporate Governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined” (OECD, 2004). Corporate Governance is a “concept rather than an individual instrument” (Raman et al., 2013). It focuses not only on the effective management and the control of corporate structures but also on the improvement of various relations of a mixture of stakeholders such as customers, Boards of Directors (BoD), shareholders, etc. (Cormier et al., 2010). It constitutes a set of mechanisms through which outside investors protect themselves against compulsory purchase by insiders (La Porta et al., 2000).

After the eruption of the recent financial crisis, the CG concept has gained nowadays a considerable attention in the business area worldwide, since failure in governance especially in banking industry can generate significant costs. The deficiencies in the leading world economies such as USA and Europe, caused by organizations’ scandals, as well as the recent financial crisis, underlined lack of confidence in the operating markets (Cormier et al., 2010). According to International Finance Corporation Report (2008), the improved role of CG is now recognized as a stability factor in most of the developing and developed countries worldwide, while points out the consequences on the macro-economic level and the financial markets’ reaction.

Using a unique dataset of 86 banks worldwide, this research examines the effects of Corporate Governance information on bank performance during the period of deep economic crisis (2008–2011), since little research in corporate governance and its impact on bank performance during financial crises exists (Fahlenbrach and Stulz, 2011; Erkens et al., 2010; Cornett et al., 2010).

The structure of the study proceeds as follows. Section 1 provides the literature review of this research. Section 2 presents the methodology and sample data. Section 3 presents the empirical results of the study while last section summarizing the conclusions and future research of this paper.

1. LITERATURE REVIEW

A great deal of literature has become available on Corporate Governance in European banks, particularly related to regulatory framework placed by the Basel Committee on Banking Supervision. Without effective Corporate Governance, banks could not promote sustainable business performance, enable them to expand rapidly and perform their role effectively. This need becomes increasingly potent, as the institutions expand and their operations become more complex. Failure, therefore, to address these challenges satisfactorily could frustrate reforms and deteriorate their potential capacity in implementing good governance performance. Moreover, CG is also described by the Organization for Economic Co-operation and Development

(OECD) that has defined it as the “set of relationships between a company’s management, its board, its shareholders and other stakeholders”¹.

According to Adams and Mehran (2012), most of the studies on board effectiveness exclude financial firms from their samples and, therefore, very little is known about the effectiveness of banking firm governance. In that context, this study at first aims to contribute to the literature in the aspects of effect of Corporate Governance information on bank performance.

The board of a bank plays a major role in order to accomplish effective governance. According to Cheng (2008), board size is a significant determinant of volatility in corporate performance, since

1 OECD, April 1999, p. 2.

variability of performance changes with board size independent of the existence of agency problems within larger boards. Liang et al. (2013) using a data sample of Chinese banks examined the impact of a comprehensive set of board characteristics on bank performance and bank asset quality. They found that the proportion of independent directors affects positively bank performance and bank asset quality, while board size impacts negatively bank performance. From their empirical results, suggesting the board of directors to play a significant role in bank governance.

Gerard et al. (2007) assess the impact of the ownership structure of banks and shareholder protection laws on bank valuations. The results show that stronger shareholder protection laws increase valuations, and greater cash-flow rights mitigate the adverse effects of weak shareholder protection laws on valuations.

Staikouras et al. (2007) examined a sample of 58 out of the 100 largest, in terms of total assets, credit institutions operating in Europe for the period between 2002 and 2004. Their analysis concluded that bank profitability, measured in terms of ROA, ROE and Tobin's Q, is negatively and significantly related to the size of the Board of Directors.

The board size is a factor inducing significantly firm performance, since it has impacts on monitoring CEOs and control activities. Large boards present positive impact on firm performance (Coles et al., 2008). For banks, the evidence of relation between board size and performance is mixed. Adams and Mehran (2012), examining the relationship between board governance and performance, found that board size is positively correlated with performance, but no correlation between independent directors and performance exists.

Another significant issue in Corporate Governance is the independence of directors. For directors of organizations with operations spread across multiple countries, the risk of non-compliance increases significantly, as such organizations need to comply with global legislations regarding a series of regulatory frameworks and practices. The previous literature does not present clear evidence on the relationship between bank performance and the role of independent directors. On the one hand, the pres-

ence of independent directors increases the quality of monitoring, but, on the other hand, they may lack firm-specific information (Liang et al., 2013).

Rowe et al. (2011) examine the effects of board governance on bank performance and found that higher board ownership and lower percentage of non-executive on board are positively correlated with bank performance. Andres and Vallelado (2008), using a data sample of 69 large commercial banks, found that bank performance presents an inverted U-shaped relation with board size and proportion of outside directors. Coles et al. (2008) found that the proportion of independent directors does not affect firm performance and Wintoki et al. (2012) mentioned no relation between board size and independent directors with firm performance. Similarly, Kula and Tatoglu (2006) argue that the role of independent directors in the decision-making process of board is not significant for firm performance, since dependent directors hold an advantage by having greater access to information. Kiel and Nicholson (2003) found that proportion of outside directors has negative correlation with firms' performance.

Lin, K., Chang, Y. (2016) examined the determinants of board structure, e.g., board size and the independent directors' ratio using data of twenty-seven banks listed on the Taiwan Stock Exchange from 2000–11. Their research shows that bank size, the degree of revenue diversification, and the CEO's shareholding are positively associated with the independent directors' ratio.

Liang et al. (2016) investigate the relations between Corporate Governance structures, level of diversification, and excess value in a sample of U.S. banks for the period 2003–2008. They find that governance mechanisms are associated with banks' diversification in a sense that whenever the level of diversification increases, board independence, institutional ownership, and managerial entrenchment decreases, whereas the ratio of certified inside board directors significantly increases. Their findings also provide some policy implications including the proper design or regulation of bank governance structures.

The proportion of female directors on board gathers increasingly greater interest worldwide. In their empirical study, Adams and Ferreira (2005) consider the role of female directors on board and

found that females are better in monitoring committees than males. However, the evidence of the impact that diversity has on firm performance is mixed. Pathan & Faff (2013) examine whether board structure (board size, independence and gender diversity) in banks correlates with performance. Using panel data from US banks during the period 1997–2011 showed that both board size and independent directors induce negatively bank performance. In addition, gender diversity improves bank performance during the period 1997–2002, while gender diversity affects negatively bank performance during the period 2003–2006 and the crisis periods 2007–2011. Carter et al. (2003) explore whether female directors on bank boards have any impact on bank performance and argue that there is a positive relation between the percentage of female directors and firm performance. Another significant issue in Corporate Governance information that concerns is CEO duality: CEO also holds the position of chairman of the board. In the literature on Corporate Governance, there are mixed findings. Tian and Lau (2001), using a data sample of Chinese listed companies, found a positive relationship between CEO duality and firm performance. In addition, limited research on the presence of auditors in bank supervisor exists. An auditor plays a major role as a bank supervisor to ensure the financial report controlling in order to improve corporate performance (Niinimaki, 2001). In this study, the impact of external audit on bank performance is examined.

2. DATA AND METHODOLOGY

2.1. Data

A cross-sectional and time series (panel data analysis) data on 86 banks worldwide are used in this research. The data sample is a balanced panel data set for the whole period of deep economic crisis (2008–2011). The bank data were derived from Reuters database.

2.2. Methodology-proposed model

In this research, a Panel Estimated Generalized Least Squares (EGLS) regression model is used in order to examine the effect of internal Corporate Governance (CG) mechanisms on banks financial performance. Based on the literature, Return on Assets (ROA) is used as a measure of bank corporate performance.

The Corporate Governance mechanisms information used as determinants of performance are: environmental measures of how well a bank uses its management practices to avoid environmental risks, board size, non-experienced board, independence of board members, CEO duality, external audit, market capitalization, total assets and common shareholders' equity (see Table 1).

The empirical model we use for the three examination periods is the following, where $\varepsilon_{i,t}$ represents the error term.

Table 1. Proposed variables

Variable	Symbol	Definition
Return on Assets	ROA	Corporate Performance of banks / Return on Assets (ROA) (= Net income / total assets) is an indicator of how profitable a bank is relative to its total assets. ROA provides a measure of efficient management
Environment	ENV (Z1 variable)	The environmental pillar measures a bank's impact on living and non-living natural systems, including the air, land and water, reflecting how well a company uses best management practices to avoid environmental risks and capitalize on environmental opportunities in order to generate long term shareholder value
Board size	BS (Z2 variable)	Number of directors on board
Non-experienced board	NONEXPB (Z3 variable)	Number of non-experienced board members
Independent board members	IND (Z4 variable)	Proportion (%) of independent directors on board

Table 1 (cont). Proposed variable

Variable	Symbol	Definition
CEO duality	CEO (Z5 variable)	Dummy variable takes value = 1 when CEO is Head of board and value = 0 when CEO is independent of board Head
External audit	EA (Z6 variable)	Dummy variable takes value = 1 when external audit exists or = 0 otherwise
Market cap	MC (Z7 variable)	Market capitalization is a measurement of business value based on share price and number of shares outstanding.
Total assets	TA (Z8 variable)	Logarithm of bank's total assets
Common shareholders' equity	CSEQUITY (Z9 variable)	Common shareholders' equity equals to a firm's total assets minus its total liabilities and is used to determine the financial health of a bank

The model used for our analysis is described subsequently for $t=2008, 2009, 2010, 2011$ (4 consecutive years), for the i -th banking institution:

$$ROA_{i,t} = \beta_0 + Z1_{i,t} + \beta_2 Z2_{i,t} + \beta_3 Z3_{i,t} + \beta_4 Z4_{i,t} + \beta_5 Z5_{i,t} + \beta_6 Z6_{i,t} + \beta_7 Z7_{i,t} + \beta_8 Z8_{i,t} + \beta_9 Z9_{i,t} + \varepsilon_{i,t}$$

The methodology used is panel data analysis with multivariate regression models based on different data segmentation. The panel EGLS (cross-section weights) with white period standard errors & covariance (no d.f. correction) to reduce heteroskedasticity is applied in this research. The software used is E-views 8.0.

3. RESULTS

The results of the model use are presented below (Table 2). For the crisis period, the results of the econometric analysis suggest that the environmental index shows negative relation to ROA at 1% significance level, as expected, related to issues of resources consumption such as electricity, paper, and efficient use of resources that lead to higher levels of banks' efficiency. Size of the board has a negative relation to profitability during the crisis period, at 1% significance level, reflecting that smaller board size tends to run banks more efficiently. These results are similar to those reported in previous studies of the banking sector (see, e.g., Busta, 2007; Staikouras et al., 2007; Tanna et al., 2008). Boards' independence strongly supports banks' efficiency at 1% significance level, while

banks' CEOs as Head of board contribute positively to banks' efficiency at 5% significance level, similar to John and Senbet (1998) concluding that the board of director's effectiveness in monitoring corporate management is fundamentally determined by its independence and size. External audit also contributes positively to banks' efficiency at 1% significance level, ensuring transparency on material issues at any stage of bank's operations providing a solid state of bank's efficiency. Also, non-experienced board and a higher presence of non-executives contribute positively to banks' efficiency at 1% significance level showing better performance in terms of the market-to-book value and return on invested capital (ROIC), which is in parallel with Busta (2007).

Table 2. Results (ROA as the dependent variable)

Variable	Coefficient	t-statistic	Prob.
C	0.706471	7.366327	0.0000 (*)
ENV	-0.005188	-4.151424	0.0000 (*)
BOARDS	-0.041591	-3.898899	0.0001 (*)
IND	0.002949	2.514714	0.0124 (**)
CEO	0.372925	19.85631	0.0000 (*)
EXTA	0.323874	5.493813	0.0000 (*)
NONEXPB	0.011825	7.932955	0.0000 (*)
TA	-1.15E-11	-3.317723	0.0010 (*)
MC	5.21E-08	1.490270	0.1371
CSEQUITY	1.54E-10	1.959789	0.0508 (**)

Notes: R-squared=0.698084, * significance at 1%, ** significance at 5%.

Table 3. Aggregate results

Variables	Abbreviation	Sign	Prob.
ENV	ENV	(-)	0.0000 (*)
BOARD SIZE	BOARDS	(-)	0.0000 (*)
INDEPENDENT BOARD MEMBERS	IND	(+)	0.0001 (*)
CEO BOARD MEMBERS	CEO	(+)	0.0124 (**)
EXTERNAL AUDIT	EXTA	(+)	0.0000 (*)
NON-EXPERIENCED BOARD	NONEXPB	(+)	0.0000 (*)
TOTAL ASSETS	TA	(-)	0.0000 (*)
MARKET CAPITALIZATION	MC	(+)	0.0010 (*)
COMMON SHAREHOLDERS EQUITY	CSEQUITY	(+)	0.1371

Also, another important finding is that market capitalization of sample's institutions is positively related to banks' efficiency at 1% significance level providing a measure of a better bank's stock valuation, providing important insights for potential interrelationship efficiency, board size and/or composition with core bank characteristics.

Specifically, as can we observe, a variable non-experienced board has a positive effect on the profit efficiency. The contribution of this group comes from decisions-making and strategy by bringing new perspectives from other businesses, constructively challenging and enriching company strategies and introducing significant sources of management experience and expertise. More specifically, in the future, it can replace the board of the bank performance and channelled through the better control of credit risk. Bearing the above issues in mind, we conclude that robust evidence is reported insinuating a negative relationship between board size and profit efficiency, as well as a strongly positive effect of independent board members, and a robust relationship between the external audit and profit efficiency. These choices for the mod-

elling of bank efficiency are motivated from the fact that the Corporate Governance characteristics implemented within a banking institution provide important and strong evidence of better bank management and decisions more thoroughly and accurately taken, influencing European banking stability. The total assets variable has a negative (-0.0000) effect at the 10% significance level, this link between total assets and profit efficiency can be explained by the fact that a bigger bank has a higher income to be subject to taxation.

In accordance with our econometric study, we can observe that the variable common shareholders equity has positive (+0.1371) effect without significance level on profit efficiency. The main guides of earnings banks remain profit efficiency, risk-taking and leverage. Various shareholders and directors emphasize different aspects of profitability. These aspects must be taken into consideration and each different group of market participants have their own preferred diverse set of indicators. For this purpose, each different group of market participants have their own preferred diverse set of indicators.

CONCLUSION. FUTURE RESEARCH

The global financial crisis has brought about many drastically changes in the management and operation of the banking system. Globalization allows the trading of technology through investing, permitting both nations to become more profitable and prosperous. Such technology exchanges may bring about substantial, brief exchange deficiencies in a few nations, however, the results from technology

ventures will soon bring about yield increments, permitting the nation to pay back financing for the venture driven exchange deficits. Effective Corporate Governance in banks, as well as the firms are a cornerstone of the new banking environment. Unfortunately, Corporate Governance is considered not to acquire an appropriate level of importance so far in most European banking institutions. This is because all the institutions before the crisis period didn't pay much attention in formulating the appropriate disciplines ensuring efficiency and integrity and place them in top priority. Crisis showed that banking institutions suffer from inefficiencies and inequities that adversely affect all stakeholders. The adverse effects of ineffective Corporate Governance can become even more demanding in case the financial institutions tend to face more unpredictable risks associated with difficulties arising from the economic crisis. Also note that under the new rules of Basel III, capital derived from the practice of deferred taxes is not considered to be of high quality. However, with relevant laws recognizing that the state will pay the amount in deferred tax even if the banks are not profitable, Greece, Italy, Spain and Portugal have recognized deferred tax as capital. In parallel, the ECB starts effort to abolish the various national rules laying of the banks, seeking the full harmonization of capital rules. According to the publication, in addition to the European Commission, the European Banking Authority shall consider whether the deferred tax issue creates unfair competition in Europe. Using a sample of European banks over the crisis period 2008–2011, our study seeks to provide evidence on Corporate Governance issues related to bank performance measured in terms of profit efficiency. The results taken out of our research suggest that smaller boards are more efficient and tend to become a win-win strategy for banks' management during the years of economic crisis. We find the negative impact of board size, while increasing the number of non-executives is positively associated with banks' profit efficiency.

External audit contributes also in a strongly positive way to banks' efficiency fostering transparency and compliance with the requirements of the regulatory framework, adopted in a parallel way with the corporate governance demands.

The present study is the beginning in a series of studies intended to be accomplished in order to provide new insights regarding stability, compliance and efficiency of the European banking and finance system. Further research could include more internal factors and a wider range of European banks. Additionally, in future studies, we can measure the impact of CG for a greater sample consisting of European or non-European banks and the upcoming effect on the global banking system.

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