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Corporate Governance and Financial Performance of Commercial Banks in Sri Lanka

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Abstract. The study sought to investigate the impact of corporate governance on financial performance of commercial banks in Sri Lanka. The study obtained the research data from annual reports of listed twelve domestic commercial banks over the period from 2012 to 2019. The researcher conducted correlation analysis and multi regression analysis to examine the objectives of the study. The findings revealed that when the board has independent directors at least two or one third of total directors. The result of correlation analysis indicates that there is a negative relationship between board size and ROA, ROE. As well as there is negative relationship between BIND and ROA, ROE. Positive significant impact of CEO duality on ROA and ROE of domestic commercial banks in Sri Lanka. The finding are useful to management body to understand the corporate governance quality status, policy makers and regulators to strictly follow up or enhance the guideline of corporate governance of commercial banks in Sri Lanka. Further, all the banks are compiled under the code of corporate governance guidelines which is lead to enhance the financial performance too and CEO duality leads to better corporate governance practices and increased bank values.

Keywords: Commercial Banks, Corporate Governance, Financial Performance

1 Introduction

Corporate governance is a worldwide accepted fundamental organizational concept which is very important for the growth, sustainability, and competitiveness of the organizations. Thus strong business ethics, sound policies and procedures, efficient and effective monitoring systems are considered characteristics of the system of good corporate governance.

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The board size, proportion of independent directors of the board and CEO duality are one of key elements of corporate governance for board effectiveness and leading to sound corporate governance. Corporate governance explains the current management approach using a blend of management information and hierarchical management structures by which senior management directs and controls the entire organization. Governance activities allow effective completeness, accuracy and timeliness of critique management information reaching the executive team, enabling appropriate management decisions and providing monitoring mechanisms to ensure that management strategies, guidance and instructions are systematically and effectively delivered.

Compliance with the Sri Lankan Institute of Chartered Accountants (ICASL) and the Securities and Exchange Commission (SEC) code of best practice on corporate governance is currently a mandatory requirement for Sri Lankan banks. This indicates that regulatory bodies are very much concerned about corporate governance because this has a direct relationship with bank performances. Corporate governance aspects are relevant because they encourage good business practices, good decision-making and investment integrity opportunities.

Besides, corporate governance code emphasizes the board should have independent directors at two or one third of total number of directors, whichever is higher and further emphasizes that non – executive directors should a majority of the board when the chairman and CEO isn't the same person. Thus, the contributions of corporate governance practices are much important for effective decision making and ultimately add value for the firm. Since shareholders are interested to receive sufficient level of return for their investment and managers prefer to increase their personal benefits. Thus, financial performance in one of the causes for arising conflict of interest between shareholders and managers. Therefor corporate governance contribution is important for independent and effective decision in the commercial banks to enhance financial performance.

The studies of Velnampy[1]; Tandelilin et al., [2] and Mashayekhi & Bazaz[3] stated that impact of corporate governance mechanism on financial performance of the corporations. Anandasayanan and Velnampy [4] also revealed that the impact of corporate governance on corporate profitability. Besides, Mohammed [5]found that weak corporate governance practices and agency problems impact to reduce the bank performance. Thus, these studies revealed that there is an impact of corporate governance on financial performance.

Since there have been many corporate collapses worldwide, corporate governance is becoming popular today. Several empirical studies were aims to identify the relationship between corporate governance and financial performance. But the fact that the study of the corporate governance in banks in Sri Lanka is not investigated. Hence, the objective of this study is to quantify the contribution of best practice in corporate governance to domestic commercial financial performance in Sri Lanka. This investigation seeks to determine the connectivity of the independence of the board, the size of the Board, the duality of CEO and financial performance and the impact of corp.

Companies will offer a high degree of governance if they share their interests with other stakeholders in the Board of Directors (BOD). The BOD is a key institution in the company's internal management and offers a key monitoring function in the management of the corporate problem [6]. This study shows that it's important to explore whether there is a genuine connection between corporate governance and the financial performance of domestic commercial banks (whether there is positive or negative relationship). This study also examines the impact of corporate governance on Sri Lankan commercial banks' financial performance. Hence, the objective of this study is to investigate the relationship between corporate governance and financial performance of commercial bank in Sri Lanka.

2. Review of Literature

The corporate governance system is followed as prominence by all companies of all over the world after the 1997 Asian crisis for the best performance of business[7]. All previous studies of developing and developed countries were used board size, Proportion of independent directors of the board, CEO duality as one of the variables in regarding to corporate governance and found the results between corporate governance and financial performance within same country or varies countries due to different size of board, proportion of independent directors of the board and CEO duality between company to company or country to country, time period covered, sample size and different research methodology employed.

Guo and Kumara [8] studied Sri Lanka's economy in the context of Sri Lankan based on corporate governance and financial performance of listed companies. In this research the share of non-executive directors has been negatively affected by the ROA. Between the separation and the performance of CEO offices from chairman, no significant correlation was established. In Velnampy [1], the executive board examined the characteristics of boards such as the size, independence of boards, gender and education qualifications of directors in 2014 using a sampling of listed business banks in Sri Lanka and found them not significantly related to company performance. CEO duality, however is negatively linked to firm performance, and suggests that if CEOs are executive, the board may not be an objective oversight that has a negative impact on commercial banks' performance.

Another research conducted in Somathilake and Kumara [9], examines whether the various corporate governance attribute influences the capital structure of listed manufacturing companies in Colombo stock exchange (CSE). This was carried out with the sample of thirty-one listed manufacturing companies in Sri Lanka for two years. Through this research finding, it is observed that there are no significant effects of corporate governance attributes except board composition on capital structure. The board composition on a significant positive effect on capital structure and also control variable liquidity has a significant negative impact on capital structure. Comparing the above two studies this finding is inconsistent with it. Because of this study are done to find the relationship between financial performance and capital structure not only corporate governance.

Perera and Aruppala[10], found that there is a positive relationship between financial performance and the number of board meetings and education levels of the board of directors. Besides that, the study concludes that a negative relationship exists between financial performance and board size, the gender composition of the board of directors, outside directors, and CEO duality. Consequently, this study concludes that there is no equivalence in the disclosure of corporate governance practices made by banks operates in Sri Lanka. Anandasayanan and Velnampy [4], also conducted a study in Sri Lanka to find out the impact of corporate governance on corporate profitability of diversified holding companies listed on Colombo stock exchange (CSE).

The relationship between corporate governance and the risk management and corporate governance and banking performance have been found by Tandelilin et al.[2], which is delicate to the type of bank ownership. The study showed that risk management and the performance of the bank are interrelated. Risk management affects bank performance significantly and vice versa. Mashayekhi and Bazaz [3] studied Iranian economics on the basis of certain business governance indices, including board size, independence of the board, board leadership and institutional board investors. This research found that small boards are more efficient due to the monitoring purpose as well as there is a positive relationship between independent directors and the firm performances. On the other hand, there is no significant negative impact on firm performances in Iran when concentrating on the issue of duality.

Cooper [11] had been researched in 2006 by using a sample of private commercial banks and find out that the presence of insiders on the board has a positive control on both director and executives in commercial banks. Ranasinghe [12], find out that Corporate Governance is a mandatory loyalty function in the present business environment and research finds out that non-compliances have resulted in a collapse of business around the world. Further, it is mentioned that the composition and relationship of the board of directors are a major concern and most of the organizations pay more attention to identify the most suitable board structure for the organization.

Mohammed [5] also studied the impact of corporate governance on bank performance in in Nigeria and this study found out that weak corporate governance practices and agency problems caused bank failures. Finally, this researcher recommended practicing the best code of corporate governance practices to enhance bank performances.

Further, Mohammed [13] also carried out specific research to examine the impact of corporate governance on bank performance and this study researcher discovered that in any financial sector stability depends on the superiority of code of corporate governance practices. Another research conducted in Nigeria by Adegbemi, Ofoegbu & Fasanya [14] also examined the impact of corporate governance on bank performance. Through this research finding, it is observed that there is a negative impact on bank performance when there is a poor corporate governance practice. They recommended delivering specific training for the board of directors and senior management to improve corporate governance practices and ethics.

Lupu and Nichitean [15]analyzed corporate governance and bank performance in Romanian banks. This study used the six years of financial data and research to find out that there is a momentous difference between the bank performances of applying sound corporate governance practices and others. That means lower corporate governance practices may lead to the lower performances of the banks. Ranti and Samuel in [16], analyzed the 21 listed Nigerian banks and Banks itself belong board size below 13 are found to be more viable than those below 13 board sizes. The study also found that the profits of larger banks are lower than those with smaller boards. Finally this study concludes that the size of the board and the financial performance of the banks is significantly negative, because an increase in board size results with an increase in the problem of the agencies (such as the directors' free retirement) within the board and the board becomes less effective.

3. Research Design

The study was categorized the variables as independent and dependent variables to examine the objective of the study. Fig. 1 shows the conceptual framework of the study.

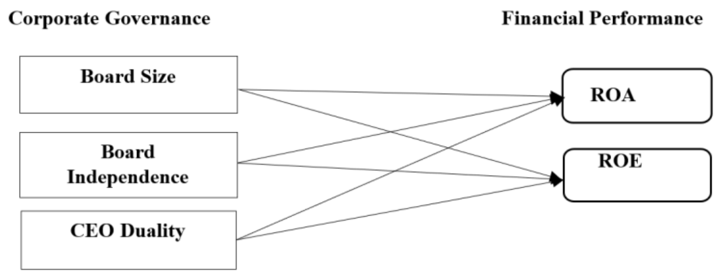

Fig. 1. Conceptual Framework

The study defined the corporate governance by the board size, proportion of independent directors on the board and CEO duality. These variables have been used by the same operationalization in study of [17]; [18].

Board Size (BSIZE)

Board size was measured by the number of directors of the company. The number of directors constituting the board of a firm can be influence its performance positively or negatively.

H_1: There is a significant relationship between board sizes on return on assets of commercial banks in Sri Lanka.
H_2: There is a significant relationship between board sizes on return on equity of commercial banks in Sri Lanka.

The proportion of independent directors on the board (BIND)

It is specifically recommended in Sri Lanka's Code of Excellence on Corporate Governance that at least two or one third of the total number of non-leading members in the board of directors should be higher. The number of non-level directors was measured in terms of the total number of directors. This variable was measured.

$H_{3:}$ There is a significant relationship between the proportions of independent directors of the board on Return on Assets of commercial banks in Sri Lanka.
$H_{4:}$ There is a significant relationship between the proportions of independent directors of the board on the Return on Equity of commercial banks in Sri Lanka

CEO duality (DUAL)

The duality of CEO is the Chairman of the Board of Directors and the CEO of the same person of the company. In the specific annual reports we have identified this variable by referring to the management section.

H_5: There is a significant relationship between CEO duality on Return on Assets of commercial banks in Sri Lanka.
H_6: There is a significant relationship between CEO duality on Return on Equity of commercial banks in Sri Lanka.

The study was defined the financial performance as dependent variable and it measure used by return on assets, return on equity ratio of the banks. Financial performance describe the financial position of a company over a given period including the collection and utilization of funds measured by several capital adequacy ratio indicators, liquidity, leverages, solvency and profitability. Capacity of the company to manage and control its resources financial performance (International Accounting Institute 2016).This variable has been used by the same operationalization in studies of [19],[20], [8],[21].

To investigate the objectives, the study was covered 12 domestic banks out of 26 commercial banks listed on the CSE for the sample periods from 2012 to 2019. The study was excluded international commercial banks listed on CSE due the fact that it is difficult to comparison of mechanism between domestic commercial banks and international commercial banks.

The researcher data was obtained from annual reports of selected domestic commercial banks for the sample period of 2012-2019 published in CSE website.

The study was formulated following multiple regression model since the study was covered cross and time series data.

$$ROA = \beta 0 + \beta 1BSIZEi + \beta 2BINDi + \beta 3DUALi + eí \text{ ----------------------- model 1}$$
$$ROE = \beta 0 + \beta 1BSIZEi + \beta 2BINDi + \beta 3DUALi + eí \text{ ---------------------- model 2}$$

Where ROA, return on assets; ROE, return on equity; β, the slope of the line; $BSIZE$i, number of directors on the board "i" for the period; *BIND*i, proportion of independent directors on the board "i" for the period; $DUAL$i, whether or not a firm's CEO is also the chair of the board of directors "i" for the period; eí, error term.

4. Finding and Discussions

The results of the descriptive and multi regression analysis are presented and discussed. this section. Descriptive statistics is used to describe the fundamental characteristics of the chosen variable.

4.1 Descriptive Statistics

The mean, average, maximum, minimum and standard deviation of all selected study variables is presented in Table 1. The study was confirmed that all selected variables are normally distributed since sample size is fulfilled the assumption of central limit theorem.

Table 1. Descriptive Statistic of Study Variables

Variables / Statistics	ROA	ROE	BSIZE	BIND	CEO Duality
Mean	1.3135	14.6024	10.36	9.33	0.19
Median	1.4000	15.4100	11	10	0
Maximum	2.50	28.40	14	13	1
Minimum	0.10	1.30	5	4	0
Std. Dev.	0.54762	6.89683	1.836	1.845	0.392
Valid N	96	96	96	96	96

The characteristic of return on assets (ROA) of domestic commercial banks shows that average value of ROA of domestic commercial banks for sample periods is about 1.31%, indicating that domestic commercial banks in Sri Lanka were earned 1.31% ROA in selected period. The median value of ROA was 1.40% for the sample periods, indicating that domestic commercial banks in Sri Lanka.

The maximum and minimum ROA were 2.50% and 0.10% respectively with the standard deviation of 0.54%. The characteristic of return on equity (ROE) of domestic commercial banks shows that average value of ROE of domestic commercial banks for sample periods is about 14.60%, indicating that domestic commercial banks in Sri Lanka were earned 14.60% ROE in selected period. The median value of ROE was 15.41% for the sample periods, indicating that domestic commercial banks in Sri Lanka. The maximum and minimum ROE were 28.40% and 1.30% respectively with the standard deviation of 6.89%.

The average number of persons on the board of directors is 10.36, with about 93.3 percent of them being independent directors on the board meeting. The characteristic of CEO duality showed that 19 % of domestic commercial banks in Sri Lanka have CEO in the board chair and 81% not have CEO in the board chair. The standard deviation was 39% for the sample periods.

4.2 Correlations Analysis

For all of the variables in the study, Table 2 provides the Pearson correlation. The association of variables of corporate governance and financial performance variables was investigated. The distinction between CEO and Chairman's roles and the financial performance as measured by ROA and ROE is a positive correlation. The proportion of non-managing directors is related to ROA and ROE negatively. Board sizes have been related to ROE and ROA in a negative way. CEO Duality indicates whether or not the Chairman of the Board of Directors is also a company chairman. The proportion of non-executive director(s) is the number of board directors; the size of the board is the number of board directors.

However, Aggarwal et al. [22] found no relationship between the size of the boards and the performance of companies. Some of them reported negative relationships between the size of boards and the company performance [23], [24], [25] . Similarly, a few other authors have proved that there is an affirmative relationship between the size of the board and corporate achievement [9], [26]. A few other studies asserted that the ratio of independent board managers to financial performance was negative [27], [28].

Some researchers have also found that independence can offer companies benefits [29], [30], [31]. There was also a positive relationship between CEO duality and financial performance from previous research findings. The relationship between the two positions was positive for [32]. Incorporating stronger financial performance compared to other companies, Rechner & Dalton [33] reported that companies with CEO Duality. Ismail & Tarofder [34] also has a significant positive impact on profitability for the CEO duality and familiar ownership fund. However, there was no connection between CEO duality and corporate performance[35].

Table 2. Result of correlation Analysis

		ROA	ROE
BSIZE	Pearson Correlation	-.364**	-.388**
	Sig. (2-tailed)	.000	.000
	Sum of Squares and Cross-products	-34.794	-466.534
	Covariance	-.366	-4.911
	N	96	96
BIND	Pearson Correlation	-.358**	-.373**
	Sig. (2-tailed)	.000	.000
	Sum of Squares and Cross-products	-34.313	-450.427
	Covariance	-.361	-4.741
	N	96	96
CEO Duality	Pearson Correlation	.531**	.334**
	Sig. (2-tailed)	.000	.001
	Sum of Squares and Cross-products	10.836	85.917
	Covariance	.114	.904
	N	96	96

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

Table 2 showed that there is the significant negative relationship between BSIZE and ROA of commercial bank in Sri Lanka at 1%significat level. Thus, alternative hypothesis (H_1) was accepted. And also the result showed that there is the significant negative relationship between BSIZE and ROE of commercial bank in Sri Lanka at 1% significant level. Thus, alternative hypothesis (H_2) was accepted. Further, there is the significant negative relationship between BIND and ROA of commercial bank in Sri Lanka at 1%significat level. Thus, alternative hypothesis (H_3) also was accepted. Moreover the result showed that there is the significant negative relationship between BIND and ROE of commercial bank in Sri Lanka at 1%significat level. Thus, alternative hypothesis (H_4) was accepted. Moreover, the result that there is the significant positive relationship between CEO Duality and ROA of commercial bank in Sri Lanka at 1%significat level. Thus, alternative hypothesis (H_5) was accepted. And also table showed that there is the significant positive relationship between CEO Duality and ROE of commercial bank in Sri Lanka at 1%significat level. Thus, alternative hypothesis (H_6) also was accepted.

4.3 Multiple Regression Analysis

The study was used multiple regression analysis is to examine the objectives while the study was covered cross and time series data. The study was tested normality test, multicollinearity test autocorrelation test to confirm whether or not selected regression model has fulfilled the classical assumption of regression model. However, the study was already confirmed that all selected variables of this study are normally distributed. Thus, the study was done multicolliniearity test and autocorrelation test for the pretesting of regression model. Finally, the study was used the selected multiple regression model to investigate the objective of the study.

Multicollinearity Test

Table 3 presents the correlation coefficient between independent variables to confirm that there is no strong correlation between independent variables of the study.

Table 3. Correlation Coefficients

Variables	BSIZE	BIND	CEO Duality
BSIZE	1.000		
BIND	0.995	1.000	
CEO Duality	0.072	0.047	1.000

According to table 3, there is no multicollinearity problem between selected independent variables since all correlation coefficients were less than 0.8 except BIND.

According to table 3, there is no multicollinearity problem between selected independent variables since all correlation coefficients were less than 0.8 except BIND.

Autocorrelation Test

The Durbin Watson statistic was used to confirm that there is no autocorrelation in the research data. Watson statistic is 1.868 which is between acceptable range of 1.5 and 2.5. Thus, it confirmed that there is no autocorrelation in the research data. The normality test, multicollinearity test and autocorrelation test were reported that selected regression model has fulfilled classical assumption of regression model. Thus, these pre testing of regression model were confirmed that the study can be used selected multi regression model with all selected variables for examine the objectives of the study. Following tables presents results of multi regression model to examine the objectives of study.

Table 4. Results of Multiple regression analysis model -1 (ROA)

Model	Coefficients	t- statistics	P-value
Constant	2.554	6.908	.000
BSIZE	-0.606	-2.301	.024
BIND	0.526	1.998	.049
CEO duality	0.724	6.062	.000
R-squared	0.382		
Adjusted R squared	0.362		
F-statistic	18.980		
P-value (F-statistic)	0.000		

As table 4 reported that F-value is 18.980 which is significant at 1% significant level. Thus, it was statistically concluded that model was fit to investigate the impact of corporate governance on financial performance of domestic commercial banks in Sri Lanka. The value of R Square was statistically concluded that 38.6% of the variation in the return on assets is explained by board size, proportion of independent directors on board and CEO duality. The remaining 61.4% of the variations in the ROA is attributed to non-selected variables in the study. Further, Table 4 showed the impact of value relevance of corporate governance on return on assets. The followings are the regression equation model value of α and ß in the result is,

$$ROA = 2.554 + (-.606BSIZE\text{i}) + .526BIND\text{i} + .724DUAL\text{i}$$

The regression result shows that there exists positive and negative relation between ROA and other variable. This multiple linear regression equation shows that ß equals to -0.606, 0.526, 0.724. That means slop of the regression line, which simply indicates that there is a significant impact of BSIZE, BIND and CEO duality on ROA. ROA has a significant impact with BSIZE (P=0.024< 0.05), BIND (P=0.049 < 0.05), and CEO duality (P=0.000 < 0.05. The value of "α" is 2.554. In this regression BSIZE, BIND and CEO duality are highly significant with the regression model.

Table 5. Results of Multiple regression analysis model -2 (ROE)

Model	Coefficients	t- statistics	P-value
Constant	35.011	6.893	0.000
BSIZE	-9.607	-2.654	0.009
BIND	8.369	2.314	0.023
CEO duality	5.634	3.435	0.001
R-squared	0.265		
Adjusted R squared	0.241		
F-statistic	11.045		
P-value (F-statistic)	0.000		

As table 5 reported that F-value is 11.045 which is significant at 1% significant level. Thus, it was statistically concluded that model was fit to investigate the impact of corporate governance on financial performance of domestic commercial banks in Sri Lanka. The value of R Square was statistically concluded that 26.5% of the variation in the return on equity is explained by board size, proportion of independent directors on board and CEO duality. The remaining 73.5% of the variations in the ROE is attributed to non-selected variables in the study. Further, Table 5 showed the impact of value relevance of corporate governance on return on equity. The followings are the regression equation model value of α and ß in the result is,

$$ROE = 35.011 + (-9.607BSIZEi) + 8.369BINDi + 5.634DUALi$$

The regression result shows that there exists positive and negative relation between ROE and another variable. This multiple linear regression equation shows that ß equals to -9.607, 8.369, 5.634. That means slop of the regression line, which simply indicates that there is a significant impact of BSIZE, BIND and CEO duality on ROE. ROE has a significant impact with BSIZE (P=0.009< 0.05), BIND (P=0.023 < 0.05), and CEO duality (P=0.001 < 0.05. The value of "α" is 35.011 in this regression BSIZE, BIND and CEO duality are highly significant with the regression model.

5. Conclusions and Recommendation

5.1 Conclusions

The descriptive statistics and multi regression analysis were used to examine the objectives of the study. The main aim of the study was to examine the impact of corporate governance on the financial performance of commercial banks in Sri Lanka. The multiple linear regression analysis provides statistical answers for the research objective to find out the impact of corporate governance (independent variable) and financial performance (dependent variable) of commercial banks in Sri Lanka. According to the findings of this study, the researcher used several dimensions such as board size, the proportion of independent directors of the board, return on assets and return on equity find the impact of corporate governance on financial performance.

The examination of the impact of corporate governance on financial performance.

Board size negatively impacts on return on assets ($\beta = -0.606$) and return on equity ($\beta = -9.607$). The findings of this result are congruent with [23],[24], [25],[36].

And also proportions of independent directors of the board is a positively impact on return on assets ($\beta = 0.526$) and return on equity ($\beta = 8.369$). CEO duality is positively impact on return on assets ($\beta = 0.724$) and return on equity($\beta = 5.634$). The results of that finding are consistent with the results of the regression analysis [4] who show that the separation between the CEOs and the Chairman has an important positive relationship with the ROA business performance.

Also, this study confirms that there is a negative relationship between the proportions of independent directors of the board and financial performance. On the issue of duality, it also has a significant positive impact on financial performance. And also, board size is negatively related to the financial performance of domestic commercial banks in Sri Lanka. According to that result, corporate governance practices are not always positively impact the financial performance of commercial banks in Sri Lanka.

On the other hand, it can be understood that there are sufficient corporate governance practices issued jointly by the Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission. So, most of the time all these banks are attempting to follow these guidelines and comply with these corporate governance practices. Then it is caused to minimize bank corruption and mismanagement issues. Then it is directly caused to improve financial performance too. Finally, this study found that there is a direct relationship between corporate governance and the financial performance of commercial banks in Sri Lanka.

5.2 Recommendations

The findings of the study are supported to policymakers and regulators nobody the Sri Lankan Government, Securities and exchange commissions of Sri Lanka, Institute of Chartered Accounts of Sri Lanka and other relevant institutes to follow up the same guideline or enhance the guideline of corporate governance for effective decision making of commercial banks in Sri Lanka. Thus, it will create a favourable Sri Lankan investment environment to the local as well as foreign investors to invest in and its lead to sustainable economic growth. Further, the finding of the study is supported to the management body of commercial banks to enhance corporate governance guideline to growing harmony between management and shareholders and signal to the stakeholders from effective decision making.

Further researchers can extend the current study for domestic commercial banks or comparing international commercial banks and domestic commercial banks. Besides, future studies can be selected other corporate governance characteristic such as board ownership, outsize directors and gender composition of the board to examine the impact of those characteristics on financial performance in domestic commercial banks or international commercial banks in Sri Lanka

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