Corporate governance and non - performing loans: evidence from listed banks in Sri Lanka

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Abstract

Non-performing loans (NPLs) plays a significant role as they reflect the credit quality of the loan portfolio of banks, and in aggregate terms, reflect the credit quality of the loan portfolio of the banking sector in a country. The study aims toexamine the influence of corporate governance on non-performing loans of listed banks in Sri Lanka for the period from 2013 to 2017. In this study, listed banks are selected as sample for the purpose of data analysis with help of Pearson's correlation and multiple regressions. Secondary data from the annual reports of banks and journals was used for the analysis purpose. The findings show that board activities have a significant influence on non-performing loans of listed banks in SriLanka whereas other corporate governance variables such as board size, board independence and CEO duality have no significant influence on non-performing loans. This study would hopefully benefit to the academicians, researchers, policy-makers and practitioners of Sri Lanka and other similar countries.

Keywords - *Corporate governance, Board activities, Non-performing loans.*

1. Introduction

Financial sector showed improved performance as the supportive prudential measures continued to preserve stability of the financial system in 2017. The improved performance of the financial sector was broad-based and mainly contributed by the banks, other deposit taking financial institutions and contractual savings institutions. Banking plays a significant role in the financial life of the organizations, and the importance of banks can be seen from the fact that they are considered as to be the life-blood of modern economy. Although no wealth is created by bank, but their essential activities facilitate the process of production, exchange and distribution of wealth. In this way they become the effective partners in the process of economic development and growth. An efficient banking sector is better able to withstand negative shocks and contribute to the stability of the financial system.

Governance has become an issue of interest ever since people began to organize themselves for a common purpose. As corporate form of entity is considered as one way of organizing people towards a common purpose, corporate governance has become a critical area of concern. It has also become a much discussed issue today owing to constant occurrence of corporate frauds, abuse of managerial power and social irresponsibility of corporate entities. Therefore, a quest for good corporate governance can be witnessed today. The term 'corporate governance' is usually defined as the system by which companies are directed and controlled (Cadbury,1992).The contribution of corporate governance for the stability and equity of society is aptly captured by the following definition of Adrian Cadbury made in 2004:"Corporate governance (CG) is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

Corporate Governance is an obligatory adherence function in the present turbulent business environment. Evidence reveal that non-compliance have resulted collapse of corporate giants around the world. Board as a corporate governance component, derived much attention consequently, practitioners and academia have tried to identify the most appropriate board structure by linking this with performance.

NPLs become one of the most serious concerns of global financial crisis for many countries of the world (Mingaleva, Zhumabayeva, & Karimbayeva, 2014). According to International Monetary Fund non-performing loan will be those with delays in payment of interests and the loan itself of 90 days or more. World Bank defined non-performing loan as the ratio between non-performing loans to total loan portfolio.

Banks internal structure and policy are interchangeably related with its total operation. Good governance depends on structural hierarchy of a bank and it denotes the corporate governance. Corporate governance is a set of principles that helps an organization to conduct its activities with integrity, fairness and transparency. With the help of corporate governance an organization is able to make necessary disclosures and decisions of its transactions with an ethical manner. Corporate governance is the widest control device, which is a hybrid of internal and external control mechanisms with a view to achieving efficient utilization of corporate resources (Chowdhury, 2012).

The soundness of the banking industry impacts on the stability of the financial system of a country and on most of the economic activities because banks play a key role in managing the flow of funds of an economy. Therefore, continuous functioning of banks with a high level of efficiency is highly important. In general, efficiency is how a firm uses its cost or effort to obtain the maximum output and it finds the ratio of inputs to outputs. The importance of bank efficiency has been widely highlighted since the last few decades in the academic literature, especially since 1990s (Hamin, Syed & Naziruddin, 2006). The bank efficiency is given attention by the management since it will be able to trace the sources of inefficiency and it will help banks enhance the chance of survival in the competitive markets (Ihsan & Kabir, 2002).

The Central Bank of Sri Lanka (CBSL) has issued a mandatory code of corporate governance – the Banking Act Direction No. 01 of 2008 on Corporate Governance for Licensed Commercial Banks in Sri Lanka in April 2008, which banks were expected to comply fully by 1st January 2009. This has been designed as a series of rules based upon certain fundamental principles, which would promote a healthy and robust risk management framework for banks with accountability and transparency through policies and oversight by the board of directors.

In this study, mainly four independent variables namely board size, board independence, CEO duality and board activities are used as the measures of corporate governance while non-performing loan ratio is the proxy for non-performing loans of the banks. Various studies have been conducted on corporate governance and bank efficiency in developed countries. However the study of non-performing loans is very rare in context of developing countries. So, this article is an endeavour to bridge the gaps in the research of non-performing loans of banks in SriLanka. The objective of this study is to examine the influence of corporate governance on non-performing loans of listed banks from the year 2013 to 2017.

The appraisal of the efficiency of the banking industry is vital for an efficient and competitive financial system due to the role it plays in financial intermediation. The developing competition itself highlights the banks to operate efficiently in the market in order to survive huge competition while protecting their market share among them.

As per the Central Bank Annual Report of 2013 thequality of assets in the banking sector worsens as indicated by the increase in the non-performing loans ratio to 5.6 per centby end 2013.Efficiency ratio that is cost to income ratio also recorded an increase from 49.4 in 2012 to 53.4 in 2013. The banking sector reported a profit after tax of Rs. 74.6 billion for 2013, compared to the profit after tax of Rs. 82.7 billion recorded for 2012. Therefore the research was guided by the research question, to what extent the corporate governance impacts on non-performing loans?

2. Literature review

Ahmed et al. (2016) investigated the impact of non-performing loan on corporate governance in Pakistan. They completed their analysis using average banking impact, foreign private banks, domestic commercial banks and state-owned banks. They concluded in every category that corporate governance has significant impact on NPL. Among the variables of corporate governance, board size is positively and board independence, ownership concentration and government form are negatively associated with non-performing loan. Here government form acts as a moderating variable since Pakistani banking sector dominated by state-owned banks.

Ahmed (2013) concluded that state-owned banks reduce bank performance and increase riskiness which has dispersed ownership and privately-owned banks increase firm performance and reduce riskiness of banks having concentrated ownership. Here, riskiness is determined by the level of non-performing. Etale, Ayunku and Etale(2016) found that doubtful loans and bad loans have significant negative association with return on common equity (ROCE) whereas and substandard loan has insignificant negative association with ROCE. All category of loans is depicted the level of non-performing loan of the sampled bank. They concluded that increase level of non-performing loan will decrease the bank performance in the long run. Vinh (2017) conducted an analysis using generalized method of moments (GMM) technique and concluded that non-performing loan has negative impact on banks performance and lending behavior. High level of NPL deteriorated the asset quality and it is the cause for low profitability. Moreover, it also reduces the ability of offering more loans or new loans in future.

Francis et al. (2012) claimed that board structure of banks has influence on the loan quality. They outlined that when the board members are able to work independently then it is quite possible to give loan by doing proper investigation. Even other board characteristics, audit committee, number of board members have also impact on the price and non-price terms of giving loan. In the Namibian Context, Sheefani (2015) explained the impact of bank specific predictors on NPL. He used time series model to analyze quarterly report from 2001 to 2014. He concluded that ROA, ROE, ratio between loan and asset and Logged Total Assets are the key bank specific factors of Non-Performing Loan in Namibia. It is commented that Banks with higher income are less interested in risky investments (Possible NPLs) as ROA and ROE are negatively associated with NPL. Asset quality and size of the total assets are positively related with NPL. It dictates the higher quality of assets, the lower chances of NPL.

Layola et al. (2016) argued that impact of corporate governance variables on the loan loss provision is mixed. With their analysis they found that meeting attendance of the board members and regulation has positive and significant impact on loan loss provision of Indian banks. On the other hand, board size, independent directors, CEO duality have negative impact on loan loss provision. Their status of relationship was also mixed in nature; some relationships were significant, and some were insignificant. They concluded with their empirical result that, when the corporate governance has no strong regulation then the level of credit risk is increasing in nature and it results in high loan loss provision.

Magembe et al. (2017) concluded that board size and CEO duality have positive impact on the non-performing loan. It means when the number of board member will increase then the quality of loan will be quite good. With this the role of power separation (Chairman of the board and managing director will be two different persons) is needed to accelerate the situation. But the role of independent director was in a questioned mark and audit committee was not able play a perfect role as both had negative association with non-performing loan.

Rose (2017) found that corporate governance structure is related with the bank's credit risk exposure. Here credit risk exposure is measured with the help of credit growth of a bank. Author claimed that inside directors (board member) are more helpful for managing the overall bank management and reduces the risk exposure of a bank. On the contrary, outside directors are not much effective for this credit risk exposure as their tenure with the bank is for short-term basis. Bussoli et al. (2015) conducted an analysis to find the impact of corporate governance on the loan quality of Italian cooperative banks. Their result showed that board dimension and quality of loan were significantly and negatively related and number of committees had negative impact on the quality of loan. It extends the meaning that more board members ensure the quality of bank management and committees without reason decelerate the quality of loan and the performance of the banks of Italy.

Fajar and Umanto (2017) conducted a study using dynamic panel data GMM-system method on 20 listed Banks in Indonesian Stock Exchange (IDX). Empirical evidence suggests that Operating Profit ratio and ROE have a positive and significant impact on NPL whereas Bank Size and Solvency ratio are in powerless in explaining NPL in Indonesian Context. Ghada and Sami (2018) found that implementing rigorous CG structures correlate with higher efficiencylevels. Particularly, the authors show that the governance structure of IBs allows them to take higher risks to achieve a high efficiency level. In addition, results show that bank efficiency and risk are positively related. Godfred (2013) identified that foreign banks are more cost - efficient than domestic banks, but not necessarily more profit - efficient. Nevertheless, foreign banks are more profitable than domestic banks and enjoy better quality loans. Managerial ownership leads to the cost inefficiency of banks. Banks with inside ownership are unprofitable overall but maintain a high loan quality.

Adnan, Rashid, Htay and Meera (2011) investigated the impact of corporate governance on efficiency of Malaysian listed banks by using a panel data analysis. Corporate governance variables are represented by board leadership structure, board composition, board size, director ownership, institutional ownership and block ownership. Efficiency is measured using two proxies; namely, ratio of non-performing loans to total loans and ratio of operating expenses to total assets. The findings show that smaller board size and higher percentage of block ownership lead to better efficiency of Malaysian banks.

Nyor and Mejabi (2013) examined the impact of Corporate Governance (CG) variables of Board Size (BS), Board Composition (BC), Composition of Audit Committee (CAC) and Power Separation (PS) on Non-performing Loans of Nigerian Deposit Money Banks; with a view to finding out whether these CG variables can be useful in curtailing the incidence of non-performing loans that have bedevilled Nigerian Money Deposit Banks. Secondary data was used from fourteen (14) quoted banks on Nigerian Stock Exchange from 2005-2011. Using multi variate regression analysis, the study finds that corporate governance variables of BS, BC, CAC and PS have no significant impact on non-performing loans of Nigerian Deposit Money Banks. Hence, the study concludes that BS, BC, CAC and PS cannot be relied upon to check the rising figure of non-performing loans of Nigerian Deposit Money Banks.

Poudel and Hovey (2013) investigated the impact of corporate governance on efficiency of Nepalese commercial banks and cover 29 commercial banks out of 31 banks from the 2005-2011 time spans. Corporate governance variables are represented by board size, independence and diligence, Audit Committee size, independence and diligence and ownership structure. The non-performing loan variable is used for bank's efficiency. The regression analysis is used to examine the relationship between corporate governance and efficiency of bank. The findings show that bigger board and audit committee size and lower frequency of board meeting and lower proportion of institutional ownership lead to better efficiency in the commercial banks.

Balagobei and Velnampy (2011) evaluated efficiency and financial sustain ability of Co-operative Rural Banks in relates, with its interest rate, operating revenue, administrative expenditure, operating expenditure, and its overheads. The result reveals that there is strong positive relationship between administrative efficiency and financial sustain ability among Co-operative Rural Banks. There is no significant relationship between staff efficiency and financial sustain ability. From the above-mentioned scholarly works on Non-Performing Loans (NPL) and Corporate Governance Practices in Banking Sector, it can be stated that the growing level of NPL can be controlled with corporate governance mechanisms.

3. Research methodology

Research methodology is the roadmap that deals with the manners in which data is collected, analysed and interpreted in order to achieve research objective. This study focuses on quantitative approach and data was analysed by using techniques of Pearson's correlation and multiple regression.

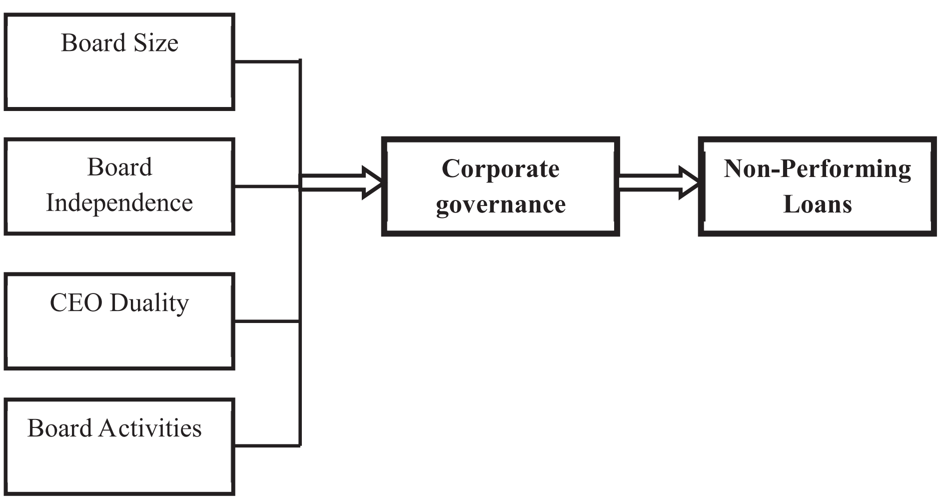
3.1 Data Collection and Sample

The data and information required for the study were collected as secondary data from the sources of annual reports of banks, annual reports of Central Bank of Sri Lanka and Journals and magazines for the five years period, from 2013 to 2017, available from the banks and CSE websites.

The population of this study is the banks listed in Colombo Stock Exchange. In this study only 10 listed banks are selected as sample by using convenience sampling technique.

3.2. Conceptualization

Figure 1 illustrates the conceptual frame work of the study.Based on the literature survey and problem statement of the study, the following conceptual model has been constructed to show the relationship between corporate governanceand non-performing loans of the banks.



Source: Developed by researcher

Figure 1. Conceptual Framework

3.3 Operationalization

Table 1. Operationalization of Concepts and variables

Concept	Variable	Measurement
Corporate governance	Board Size (BS)	Number of directors on the board of the firm
	Board Independence (BI)	Number of independent directors / total number of directors on board.
	CEO duality (CEO)	Coded “1” if Chairman also holds the position of CEO and “0” other wise
	Board Activities (BA)	The number of board meeting held during the financial year
Non-performing loans (NPL)	Non-performing loans ratio	Non-performing loans /total loans

3.4. Model of the Study

Multiple regression analysis is a statistical tool for the investigation of relationship between the variables. This study involves more than one independent variable and is therefore a multiple regression analysis used to drive conclusion. This study uses the following regression specification:

$$NPL = \beta 0 + \beta 1BS + \beta 2BI + \beta 3CEO + \beta 4\ BA + e$$

Where,

β0, β1, β2, β3, β4, -Regression co-efficient

NPL−Non-performing loan

BS - Board Size

BI - Board Independence

CEO – CEO duality

BA - Board Activities

e - Error terms.

4. Results and Discussion

4.1: Correlation Analysis

Table 2. Correlation Matrix

Variables	Board Size	Board Independence	CEO Duality	Board Activities	NPLs
Board size	1				
Board Independence	-.197*	1			
	.048				
CEO Duality	-.178*	.058	1		
	.042	.796			
Board Activities	-.457**	.576*	.728*	1	
	.000	.035	.040		
NPLs	.057	-.219	.451	-.281	1
	.867	.082	.368	.248	

*. Correlation is significant at 0.05 levels (2 tailed)

**. Correlation is significant at 0.01 levels (2 tailed)

The Pearson's correlation was made to examine the pattern or strength of the relationship between corporate governance variables and non-performing loans presented in table 2. It describes the correlation matrix between corporate governance variables and non-performing loans. The value of correlation between board size and non-performing loans is .057 which is not significant at 5% levels. Therefore board size is not correlated with non-performing loans. Correlation coefficient between board Independence and non-performing loans is -0.219 which is significant at 10% levels, represents a weak negative relationship between board independence and non-performing loans. CEO duality (r=.451, p=.368 > 0.05) and board activities (r=-.281, p=. 248 > 0.05) are not correlated with non-performing loans as per the correlation matrix.

4.2 Multiple Regression Analysis

Regression analysis is used to examine the impact of corporate governance variables on non-performing loans. The table 3 presents the multiple regression summaries for non-performing loans. The R2 value is 0 .318 which denotes that 31.8% of the observed variability in non-performing loans can be explained by differences in corporate governance variables namely board size, board independence, CEO duality and board activities. The Remaining 68.2% is not explained which means that the remaining 68.2% of the variance in non-performing loans is related to other variables not depicted in this model. R2 values of 31.8 % indicate that there may be number of variables which can have an impact on non-performing loans that need to be studied. Hence this area is indicated as a scope for future research. According to these results the coefficient of board activities is 0.586 which is significant at 0.05 levels. Further, this model reveals that the coefficient for other three variables such as board size, board independence and CEO duality are not significant at 0.05 levels. t values for these variables of corporate governance are insignificant at 5% level. It means that these variables are not contributing to the non-performing Loans. This finding is collaborated with previous study such as Nyor and Mejabi (2013).

Table 3. Coefficients for predictors of Non-Performing Loans

Model	B	Std. Error	t	Sig
Constant	19.063	12.583	1.286	.026
Board size	-.174	.278	-.546	.374
Board independence	-2.175	1.686	-1.280	.116
CEO duality	.264	.288	.664	.128
Board activities	.586	.493	.406	.036
R^2=.318			F value =12.33 (0.00)	

Dependent Variable: Non Performing Loans

5. Conclusionand Recommendations

The objective of this studyis to investigate the influence of corporate governancemechanism i.e. board size, board independence, CEO duality and board activities onnon-performing loans of banking industry in SriLanka.The results reveal that board activities in corporate governance variables have a significant influence on non-performing loans of listed banks in Sri Lanka. The studycontributes to the existing literature from different perspective and is trying to bridge the gaps in the research of relationship between corporategovernance mechanism and non-performing loans in SriLanka. Moreover, the study cover 10listed banks operated in Colombo Stock Exchange and more recent period, the year 2013-2017, when most of the regulatory decisionswere taken by the central bank of Sri Lanka for the corporate governance. The findings of this study have important implication for bank in SriLanka since it is found that large board activityhas a significant influence on non-performing loans in Sri Lanka.

The Board of the banks strives to add value in addition to achieving the basic compliance requirements and hence discharge its oversight responsibilities very effectively and efficiently to meet the objectives of all its shareholders. The board members should possess a wide range of knowledge, skills and personal attributes which includes sound judgment, integrity and high ethical standards and more so the ability and willingness to challenge and probe into the day to day operational decisions of the bank. Further, to fulfil the governance responsibilities, the board should also have clear lines sight into management's decision- making and risk management processes.

The empirical results from this study could be useful and may have significant implications for policymakers, bankers and academicians in the Sri Lanka. The policymakers may devise policies to ensure that bankers monitor the non-performing loans. Besides, the policymakers should reform new policies geared towards proper dimensions of corporate governance. Reduced NPL will move the economy forward in a more stable direction and foster a sustainable and competitive banking sector.

Therefore Central Bank, with the association of governmental bodies, need to take effective measures to strengthen the legal framework and the institutional environment. These measures guarantee a better control of non-performing loans and ensure the stability of the financial system. Finally, to better understand the interaction and the relationship between corporate governance variables and bank's non-performing loans, further investigations are needed to include internal auditing, voluntary disclosure and culture factors. The limitation of this study is that it relies only on financial statements of banks. It may suffer from the various errors and manipulations. Next, the study considers only listed banks and collected the data form secondary sources for the period of five years. The results may differ if multiple years are considered for analysis. Based on the study, other corporate governance mechanism which is not studied in this research may have a very significant contribution to banks' efficiency.

There are some suggestions for future research. Mainly four independent variables namely board size, board independence, CEO duality and board activitieswere used as the measures of corporate governance among numerous variables of corporate governance. Audit committee size, audit committee independence, board diversity, number of audit committee meetings, and number of non-executive directors can be used in the future researches.

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