Innovations

# Corporate governance mechanisms impact on commercial banks' financial performance with reference to selected private commercial banks in Ethiopia

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***Abstract***

*The main objective of this paper was to investigate corporate governance mechanisms impact on commercial banks' financial performance. Nine years data for the period 2012 up to 2020 was used to study fourteen private Ethiopian commercial banks. Purposive sampling technique was adopted to pick these banks based on the effective operation and availability of data for the study period. Secondary sources of data were used. These data were obtained from Audited annual financial statements of the private banks for the period of 2012 to 2020 from the National Bank of Ethiopia and board characteristics related data were gathered from each selected bank in the study. Descriptive statistics was used to quantitatively describe the essential features of the variables. This study also used correlation analysis to find out the level of relationships between variables and panel regression model to conduct inferential analysis using ROE as proxy for the banks' financial performance. SPSS statistical software package was used to analyze the quantitative data. Corporate governance variables considered in this study include Capital Adequacy Ratio, Liquidity Position and bank leverage and the control variable included in the study was bank size. Findings of the study signified Capital Adequacy Ratio was negatively and strongly correlated with ROE. Bank leverage and bank size had positive relationship with return on equity. The regression result depicted that capital adequacy ratio had a significant and negative impact on return on equity. Both liquidity position and bank size had positive and statistically significant impact on banks' financial performance in Ethiopia. Banks should give due attention to the optimum level of capital adequacy ratio because high capital adequacy ratio adversely affects return on equity of the private commercial banks. Banks should focus on diversification of their operation and works towards increasing their number of borrowers which leads to improve the economies of scale of banks so as to magnify their return on equity.*

***Keywords:*** *1.Corporate Governance, 2.Return on Equity, 3.Financial Performance, 4.private Commercial Banks and Ethiopia*

## 1. Introduction

Corporate governance plays a major role in macroeconomic stability; provide the appropriate environment for economic growth as well as society welfare, therefore international institutions give major attention and concerns to this issue at the level of macro and micro aspects. It is a set of relationships between a company's management, its board, its shareholders, and other stakeholders and 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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more effectively (OECD, 2004)

Iskander & Chamlou (2000) stated that the internal mechanisms for corporate governance are strengthened by external laws, rules, and institutions that provide a level, competitive playing field and discipline for the behavior of insiders. Formal legal and regulatory obligations are part of the external incentive structure designed to ensure that competing companies abide by common standards of fairness, transparency, accountability, and responsibility to protect shareholders, consumers, workers, the environment, and even competitors from abusive practices. A good legal and regulatory framework efficiently addresses the entry, operations, and exit of firms.

As per Okoi, Ocheniand John (2014) the concept of corporate governance has attracted a good deal of public interest in recent years, because of its apparent importance on the economic health of corporations and society in general. Basically, corporate governance in the banking sector requires judicious and prudent management of resources and the preservation of resources of the corporate firm; ensuring ethical and professional standards and the pursuit of corporate objectives, it seeks to ensure customer satisfaction, high employee morale and the maintenance of market discipline, which strengthens and stabilizes the bank.

According to Ball, (2012) one of the core purposes of bank regulation is to prevent bank failures. Regulators try to reduce two problems at the root of bank failures. One is the phenomenon of a bank run. The second source of failure is a problem of moral hazard: owners and managers of banks may misuse the funds they are given by depositors. To address these issues, regulators limit the types of assets that banks can hold in their balance sheet, and set minimum levels of capital that banks must maintain. John et al. (2016) point out that regulators intervene to modify the corporate governance of banks. The main rationale of bank regulation is the safety and the soundness of the financial sector, reducing systemic risks and protecting depositors

Corporate governance mechanism is an important method for companies agency cost and helps improve performance. Given the importance of corporate governance, several studies have been conducted in developed countries on the relationship between corporate governance mechanisms and firms' financial performance and found mixed results (positive and negative impact) ( Bauer, et aI., 2008;Lupu & Nichitean, 2011).
Nevertheless, majority of the previous studies were carried out on large firms operating within well organized corporate governance mechanisms in developed economic system.
Thus, it is difficult to conclude that the same result from the findings of those studies for considerably ill organized market and in the absence of secondary market in Ethiopian commercial banks' governance mechanisms. In Ethiopia the corporate governance of banks is directed and supervised by the National bank of Ethiopia. The National Bank of Ethiopia monitors and controls the banking business and functions as regulators of the country's money supply and policy institutions.
Despite the volume of the empirical work, there is no consensus on the impact of corporate governance on firm's financial performance. In Ethiopia very few researches have been conducted on this issue and leads to mixed results. The main aim of this study is to investigate the impact of corporate governance mechanisms on firms' financial performance considering the gap to be addressed.

## 1.1. Research Objective

### 1.1.1. General Research Objective

The main objective of the study was to investigate the impact of corporate governance mechanism on the financial performance of private commercial banks in Ethiopia.

### 1.1.2. Specific Objectives

1. To explain the relationship between capital adequacy ratio and bank financial performance.
2. To identify the relationship between liquidity position and bank financial performance.
3. To find out the relationship between bank leverage and bank financial performance.

## 1.2. Hypotheses

**Ho1:** There is no relationship between capital adequacy ratio and commercial banks financial performance.
**Ho2:** There is no relationship between liquidity position and commercial banks performance.

**Ho3:** There is no relationship between bank leverage and bank financial performance.

## 1.3. Scope of the Study

This study was delimited to the examination of the impact of corporate governance mechanisms on selected private commercial banks' financial performance in Ethiopia using data available from the year 2012 up to 2020. The dependent variable was delimited to return on equity. The independent variables were delimited to Capital Adequacy Ratio, Liquidity Position and bank leverage. The study area was delimited to private commercial banks in Ethiopia which had available data for the specified study period.

# 2. Review of Related Literature

One of the primary aims of shareholder in recent decades has been the promotion of good corporate governance practices as a means to improve corporate performance and shareholder financial performance. Performance is a complex concept, in terms of both definition and measurement. It has been defined as the result of activity, and the suitable measure selected to assess corporate performance is considered to depend on the type of institution to be evaluated and the objectives to be achieved throughout that evaluation process (Hunger & Wheelan, 1999).
The organization systems, practices, process and rules of governing institutions are concerned closely with the corporate governance so there is a need to find those relationships that regulate, create or determine the nature of relationship through those relationships. Corporate governance implies that companies should balance between the interests of shareholders with stakeholders at all levels of organization (Okeahalam and Akinboade, 2003).
According to Al-Hawary (2011) the multiplicity of stakeholders complicates financial sector corporate governance. In addition to investors and depositors, organizers are directly concerned with the bank's performance. At the macroeconomic level, organizers are concerned with the effect of governance on financial institutions' performance, because the economy's health and safety largely depends on their performance. Banking efficiency is important at both macro and micro levels and in order to allocate resources effectively, banks should be sound and efficient (Hussein, 2000).
Due to the tight regulation of government, corporate governance works in a different way in the banking sector. Andres, P and, Vallelado, E. (2008) stated that banks are generally more opaque than nonfinancial firms and evidence suggests that informational asymmetries are larger in banks than in other sectors.

Corporate Governance in the banking system has assumed heightened importance and has become an issue of global concern because it is required to lead to enhanced services and deepening of financial intermediation on the part of the banks and enables proper management of the operations of banks. To ensure this, both the board and management have key roles to play to ensure the institution of corporate governance (Nworji, Adebayo and David, 2011).

### 2.1. Capital Adequacy Ratio

Central bank regulation is exercised through the use of various financial ratios of individual banks such as capital adequacy ratio.According to Tandelilin, E (2007) The CAR of individual banks, is a good indicator of the implementation of good corporate governance practice in the bank. As per Konishi, M & Yasuda, Y (2004) the implementation of the capital adequacy requirement reduces risk taking behavior of commercial banks. National Bank of Ethiopia under its directive no. SBB/50/2011 has set a minimum capital to risk weighted asset ratio of 8% to be maintained by all licensed banks to enable withstand adverse operational results.

**Ho1:** There is no relationship between capital adequacy ratio and commercial banks financial performance.

### 2.2. Liquidity Position

Liquidity position is the type of regulation used by national bank of Ethiopia to protect private commercial bank stakeholders. Most of the empirical study conducted by Kyereboah-Coleman (2007) and Yenesew (2012) found that the liquidity ratio requirement from NBE to private commercial banks in Ethiopia had a negative effect on their profitability while some other study by Olajide (2013) and Rose (2007) was found positive relationship thereof.

**Ho2:** There is no relationship between liquidity position and commercial banks financial performance.

### 2.3. Bank Leverage

Different authors explain that sound corporate governance and an optimal capital structure are necessary for every firm to enhance the market value of the firm.

Berger (2002) stated that corporate governance theory predicts that leverage affects agency costs and thereby influences firm performance. Leverage reduces the agency costs of outside equity and increases firm value by constraining or encouraging managers to act more in the interests of shareholders.

**Ho3:** There is no relationship between bank leverage and bank financial performance

## 3. Research Methodology

### 3.1. Research Design

The main objective of this study was to explored corporate governance mechanisms impact on commercial banks' financial performance. Quantitative research design was used to investigate the relationships between the dependent and independent variables which involved descriptive and inferential statistical analysis and multivariate regression analysis. Marczyk et al., (2005) stated that the explanatory type of research design helps to identify and evaluate the causal relationships between the different variables under consideration panel data study design which combines the attributes of cross sectional and time series data was used. According to Gujarati (2004) the advantage of panel data analysis is that more reliable estimates of the parameters in the model can be obtained.

### 3.2. Population and Sample Selection

Based on the official website of National Bank of Ethiopia, in Ethiopia there were 16 private commercial banks in operation at the time of conducting the study. Fourteen private commercial banks were selected. Purposive sampling technique was adopted to pick these banks based on the effective operation and availability of data for the study period.

### 3.3. Types and Sources of Data

Secondary sources of data were used. These data were obtained from Audited annual financial statements of the private banks for the period of 2012 to 2020 from the National Bank of Ethiopia and board characteristics related data were gathered from each selected bank in the study.

**3.4. Data Analysis Technique**

Descriptive statistics was used to quantitatively describe the essential features of the variables. This study also used correlation analysis to find out the level of relationships between variables and panel regression model to conduct inferential analysis using ROE as proxy for the banks' financial performance. Some statistical software packages were used to analyze the quantitative data.

## 3.5. Variables Description and Measurements

**Dependent Variable:**

**Return on Equity (ROE):** It is a vital measure of a firm's profitability that reveals how much profit it generates with the money shareholders have invested.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

**Independent Variables:**

The independent variables of the study were Capital Adequacy Ratio, Liquidity Position and bank leverage and the control variable included in the study was bank size.

**3.6. Specification of the research model**

To estimate the corporate governance mechanisms impact on the financial performance of sample private commercial banks in Ethiopia, the following general empirical research model was developed.

$Y_{it} = \beta o + \beta 1K_{it} + \beta 2C_{it} + + \varepsilon_{it}$

$Y_{it}$ : stand for the dependent variable, representing the financial performance of the sample banks i for time t

The Model with ROE as dependent Variable is:

$ROEit = \alpha + \beta 1CARit + \beta 2LPit + \beta 3BLit + \beta 4BSit + \varepsilon_{it}$

## Results and Discussion

**4.1. Assumption Tests**

After running the model independently, the data sets were tested for the classical linear regression model assumptions in panel data analysis. This is required to show that the estimation technique has a number of desirable properties and that hypothesis tests regarding the coefficient estimates could validly be conducted. Hence, diagnostic tests were conducted to determine realization of underlying assumptions.

**4.1.1. Linearity**

The assumption requires the mean of the disturbances to be zero. If a constant term is included in the regression equation, this assumption will never be violated. Consequently, in the model of this study a constant term is included. As a result this assumption was not violated.

**4.1.2. Assumption of No Autocorrelation**

It is assumed that the errors are uncorrelated with one another. Durbin-Watson (DW) test statistic of 2 and close to 2 results a no autocorrelation in the residuals. Hence, DW test was conducted to verify that the assumption and was not violated. From table 4.3 below DW for the model was 1.615 a value close to 2. The null hypothesis of no autocorrelation was not rejected; hence the model had not violated the assumption.

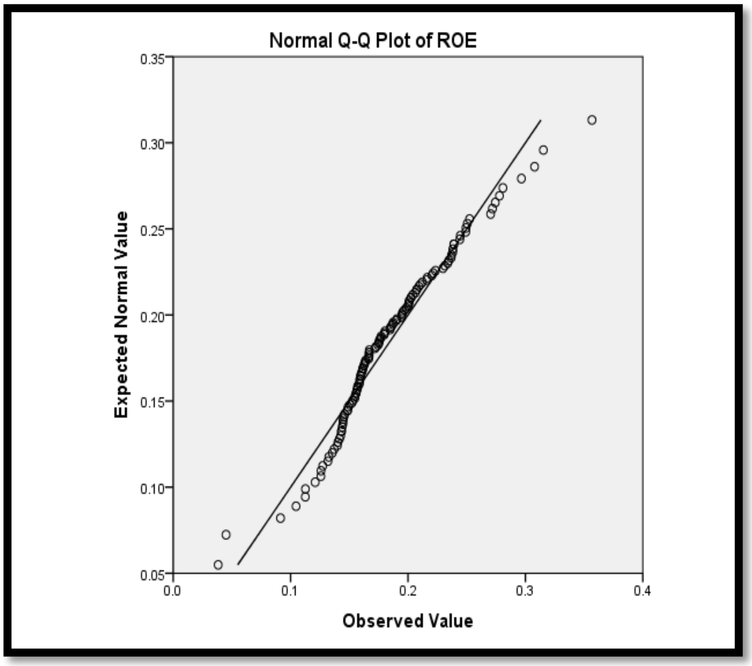
### 4.1.3. Multi collinearity Test

Gujarati (2004) stated that the larger the value of Variance Inflation Factor (VIF) the more collinear the variable is. As a rule of thumb, if the VIF of a variable exceeds 10, that variable is said be highly collinear. As it is shown in table 4.5 VIF for all the variables was below 10. Thus, there was no problem of multicollinearity.

### 4.1.4. Normality Assumption

If the variable is from a normal population, the probability plot will assume an approximate straight line (Gujarati, 2004). The distribution is normal at 5% level.

**FIGURE 4.1: NORMALITY TEST**




### 4.2. Descriptive Statistics

The descriptive statistics provide detailed description of dependent, independent and control variables. The dependent variable used in the study to measure the sample private commercial banks' financial performance was ROE and the explanatory variables were Capital Adequacy Ratio, Liquidity Position and bank leverage and the control variable included in the analysis was bank size.

## Table 4.1 Descriptive Statistics for the Study Variables

| Descriptive Statistics | | | | | |
|---|---|---|---|---|---|
| **Variables** | **Obs** | **Minimum** | **Maximum** | **Mean** | **Std. Deviation** |
| **ROE** | 126 | .038 | .357 | .18407 | .050078 |
| **CAR** | 126 | 7.87 | 25.95 | 14.6513 | 3.53117 |
| **LP** | 126 | 13.00 | 51.43 | 29.6782 | 10.61252 |
| **BL** | 126 | 1.62 | 11.70 | 6.1848 | 1.71855 |
| **BZ** | 126 | 8.63 | 10.95 | 10.0428 | .46062 |

As it is depicted in table 4.1 the mean value of ROE of the sample private banks was 18.407 percent, on average for 1Birr investment made by equity shareholders the banks earned Birr 18.407. The minimum and maximum value of ROE for the banks was 3.8% and 35.7% respectively. This is clearly shows that from the sampled private commercial banks during the study period the most profitable private commercial banks achieved a profit of Birr 35.7 per a birr invested by equity shareholders. On the contrary, the least profitable private commercial banks earned birr 3.8 per one birr investment made by equity shareholders. The standard deviation of ROE was 0.050078 (5.01%) from the mean value of the sample private commercial banks.

The average value of capital adequacy ratio was 14.65%, with minimum value of 7.87%, a ratio slightly below the minimum statutory requirement of 8% of the National Bank of Ethiopia. The maximum CAR was 25.95% with standard deviation of 3.53% from the mean value. The average mean value of liquidity position was 29.678%; with minimum and maximum values of 13% and 51.43% respectively and standard deviation of 10.613%. Banks on average held 29.678% of their money in the form of liquid assets. This is higher than the legal requirement of 20% set by the National Bank of Ethiopia.

Leverage ratio of the private banks had mean value of 6.1848% with minimum and maximum values of 1.62% and 11.70% respectively and standard deviation of 1.71855%.

The average value of the bank size was 10.0428 and having a maximum value of 10.95 and a minimum value of 8.63. The standard deviation of bank size of the sample private commercial bank was 0.46062. The standard deviation of the private commercial banks implies that there was no such a wide dispersion in the size of the sample Ethiopian private commercial banks.

### 4.2 Correlation analysis

Correlation analysis helps to identify the relationship between the study variables. The correlation coefficients illustrate the magnitude and path of the relationship between corporate governance variables and ROE of the sample Ethiopian private commercial banks. In the table 4.2 below, the correlation matrix which demonstrates the relationship of the ROE with Capital Adequacy Ratio, Liquidity Position, bank leverage and bank size. You can figure out that bank leverage and bank size were positively and strongly correlated at 1 percent significance level with ROE. Liquidity Position had a small degree of positive involvement but extremely weak correlation. On the other hand, Capital Adequacy Ratio was negatively and strongly correlated with ROE at 1% confidence level.

**Table 4.2**

**Pearson Correlations**

| Variables | ROE | CAR | LP | BL | BZ |
|---|---|---|---|---|---|
| ROE | 1 | | | | |
| CAR | -.458** .000 | 1 | | | |
| LP | .102 .254 | .454** .000 | 1 | | |
| BL | .465** .000 | -.935** .000 | -.390** .000 | 1 | |
| BZ | .235** .008 | -.640** .000 | -.762** .000 | .600** .000 | 1 |

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

**4. 3. Regression Results and Discussion**

This study used Panel data regression analysis to find out the statistical dependence of ROE on the corporate governance proxies of Capital Adequacy Ratio, Liquidity Position, and bank leverage and bank size. As shown in the table 4.3 below, adjusted R square of the model implies that 36.3% of variation in ROE was explained by the independent and control variables used in this study and the remaining was explained by other factors.

**Table 4.3**

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
|---|---|---|---|---|---|
| 1 | .619[a] | .384 | .363 | .039959 | 1.615 |

a. Predictors: (Constant), BZ, BL, LP, CAR
b. Dependent Variable: ROE

The F-statistic demonstrates the overall significance of variables. The p-value was 0.000, which is less than 5% and proves that the model is appropriate to explain the panel data. Hence, the test used in the analysis of variance confirms the joint significance of all the factors in explaining the ROE.

**Table 4.4**

**ANOVA**

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | .120 | 4 | .030 | 18.831 | .000[b] |
| | Residual | .193 | 121 | .002 | | |
| | Total | .313 | 125 | | | |

a. Dependent Variable: ROE
b. Predictors: (Constant), BZ, BL, LP, CAR

The regression outcome presented in the table 4.5 below depicts the regression results of each corporate governance variables impact on financial performance of private Ethiopian commercial banks. Coefficient estimates and p-values were observed to determine direction and significance levels.

The p- value and t-statistic of capital adequacy ratio were 0.073 and -1.808 respectively indicating capital adequacy ratio had a significant impact on ROE at 10 percent level of significance and it had a negative coefficient. This negative value indicates that the increase in capital adequacy ratio causes the decrease of bank's financial performance measured by ROE. The coefficient parameter for liquidity position was 0.003 with p-value of 0.000. The result confirms that liquidity position had a positive and statistically significant impact on bank financial performance at 1 percent level of significance. It was the same result produced to the bank size variable. The regression result indicated that bank size had statistically significant and positive relationships with ROE with a coefficient of 0.043 and p value of 0 .003. This implies that as banks increase in size, their financial performance proportionally increases. The regression results showed that bank leverage had positive but insignificant influence on bank financial performance as measured by ROE. The p- value and t-statistic of bank leverage were 0.589 and 0.542 respectively and the coefficient parameter for bank leverage was 0.003.

### Table 4.5 Regression Analysis for the Study Variables

**Coefficients**

| | Unstandardized Coefficients | | | | 95.0% Confidence Interval for B | | Collinearity Statistics | |
|---|---|---|---|---|---|---|---|---|
| Variables | Beta | Std. Error | **t-statistic** | **Sig.** | Lower Bound | Upper Bound | Tolerance | VIF |
| (Constant) | -.277 | .171 | -1.620 | .108 | -.616 | .062 | | |
| CAR | -.005 | .003 | -1.808 | .073 | -.011 | .001 | .114 | 8.786 |
| LP | .003 | .001 | 5.562 | .000 | .002 | .004 | .408 | 2.454 |
| BL | .003 | .006 | .542 | .589 | -.009 | .015 | .122 | 8.207 |
| BZ | .043 | .014 | 3.084 | .003 | .015 | .071 | .307 | 3.259 |

a. Dependent Variable: ROE

## 5. Conclusions and Recommendation

### 5.1. Conclusions

The intention of this study was to explore the impact of corporate governance mechanisms on financial performance of private commercial banks in Ethiopia. Banks play a crucial role in any economy. They are engaged in the transfer of funds from those who have the fund to those who need the fund. It is due to this governments give high attention to these financial institutions. Based on the results and discussion the researcher made the following conclusions;

Based on the descriptive statistics the average mean of the sample commercial banks' financial performance measured by return on equity was 18.407 percent that is shareholders of the private commercial banks earned on average around 18.4% from their investment.

From the correlation analysis result capital adequacy ratio was negatively correlated with ROE. There was an inverse relationship between the two. Bank leverage and bank size had positive relationship with return on equity. Thus, as these two variables increase or decrease, return on equity also proportionally increases or decreases.

The regression result depicted that capital adequacy ratio had a significant and negative impact on return on equity at 10 percent level of significance. This evidently implies that high capital adequacy ratio affects negatively the financial performance of private commercial banks of Ethiopia. Both liquidity position and bank size had positive and statistically significant impact on banks' financial performance in Ethiopia. Hence, as both of these variables increase or decrease in magnitude, the return on equity of private commercial banks proportionally increases or decreases.

**5.2 Recommendation**

Based on the major findings of this study, the following essential points were suggested as recommendations:

- It is quite obvious that maintaining minimum capital adequacy ratios serves to protect depositors and promote the stability and efficiency of the financial system by reducing the likelihood of banks becoming insolvent. Banks also should give due attention to the optimum level of capital adequacy ratio because high capital adequacy ratio adversely affects return on equity of the private commercial banks.
- Although liquidity position had positive impact on return on equity, banks should be cautious on the extent of the liquidity position because extremely high liquidity ratio can unfavorably damage the banks return on equity.
- Banks should focus on diversification of their operation and works towards increasing their number of borrowers which leads to improve the economies of scale of banks so as to magnify their return on equity.
- Further research is suggested because this study considered only external corporate governance mechanisms.

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