Innovations

Effect of corporate governance on financial performance of private commercial banks in Ethiopia

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Abstract
This paper entitled "Effect of Corporate Governance on Financial Performance of Private Commercial Banks in Ethiopia." Banks serve a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. The aim of this study was to examine the effect of corporate governance on financial performance of private commercial banks in Ethiopia. The data used in the study was from secondary sources and the sample size was determined using purposive sampling. The study used descriptive data analysis, Pearson correlation analysis and multiple linear regression model to conduct inferential analysis to determine causal relation of the panel data. All most half of the explanatory variables were strongly correlated with return on asset. The regression analysis depicted a mixed result. Some independent variables such as liquidity position and bank size had positive and significant impact on financial performance and others like board independence and capital adequacy ratio had positive but insignificant effect on financial performance.

Keywords: 1.*corporate governance, 2.financial performance, 3.commercial banks, 4.board of directors,5. Ethiopia*

1. Introduction

Corporate governance recently has become a concern of global importance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations (Ibrahim et al., 2010).

Corporate Governance, in a business entity, may perhaps be called a sunshade term surrounding specific issues arising from interactions among top management, shareholders, board of directors and the public at large.

Abu-Tapanjeh (2006) suggested that good corporate governance is a fundamental necessity to keep on running a firm successfully. It has long been played a crucial role for enhancing the long-term value of stakeholders in the business environment. Corporate governance provides a structure that works for the benefit of the firm and can help in increasing firm's performance by reducing agency problem (Khan et al., 2011).

The purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies (Organization for Economic Cooperation and development, OECD, 2015).

Alem, (2011) stated that effective and good corporate governance is important to the proper functioning of the corporation and it improves economic efficiency and growth as well as enhances investor confidence.

Banks serve a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole (Basel committee on banking and supervision, 2014).

The Basel code of Corporate Governance for banks and financial institutions generally relate to the responsibilities of the Board, Directors, Chairmen, CEOs, senior management, Board appointed committees, auditors, shareholders and regulators. Accountability, internal controls, related party transactions, conflicts of interest, information disclosures have also been extensively dealt with and targeted in the formulation of these principles.

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 (Organization for Economic Cooperation and development, OECD, 2015).

According to Desta & Rao, (2016) the banking sector performs very important functions to the growth of capital formation and investment as well as for economic development in Ethiopia. Banks have responsibilities to activate deposits from the public and spread loans and advances to customers. They also involve in financing public projects, which contribute to the development of the country. Therefore, proper functioning and good performance of banks is very crucial for the economic growth of Ethiopia. By considering these factors, banks are regulated by directives issued by National Bank of Ethiopia. However, besides to these directives, banks themselves need to practice some corporate governance principles that safeguard the interests of shareholders and other stakeholders to ensure effective corporate governance in the banks.

As it is stated by different researchers performance of banks is affected by good corporate governance practice and policies. Despite this aspect, little attention has been paid to the research of corporate governance mechanisms in less developed economies in general and in Ethiopia in particular.

Ethiopian commercial banks corporate governance is distinguished by the absence of an organized share market and the country has different regulations, practices, and economic aspects which

require conducting a separate study. The purpose behind this endeavor is to awake the banking industry of Ethiopia about the benefits of good corporate governance and its effect on financial performance so that they can avail all opportunities to compete not only at national level but also at international level as well.

1.2. Research Objective

1.2.1 General objective of the study

The objective of this study is to examine the effect of corporate governance on financial performance of private commercial banks in Ethiopia.

1.2.2 Specific Objectives of the Study

1. To examine the relationship between board size and bank financial performance.
2. To investigate the relationship between independent board directors and bank financial performance.
3. To assess the influence of number of board sub committees on bank financial performance.
4. To identify the effect of Board Meeting frequency on commercial bank's financial performance.
5. To examine the association between board gender diversity and bank financial performance.
6. To explain the relationship between size of audit committee and financial performance of commercial banks.
7. To explain the relationship between capital adequacy ratio and bank financial performance.
8. To identify the relationship between liquidity position and bank financial performance.

1.3. Hypotheses

In this study the following testable hypotheses were developed.

Ho1: There is no significant relationship between board size and commercial banks financial performance

Ho2: There is no significant association between independent board directors and commercial banks financial performance

Ho3: There is no relationship between number of board committees and commercial banks financial performance

Ho4 There is a no significance relationship between frequency of board meeting and commercial banks financial performance.

Ho5: There is no significant association between board gender diversity and commercial banks financial performance

Ho6: There is no significance relationship between size of audit committee and commercial banks financial performance.

Ho7: There is no relationship between capital adequacy ratio and commercial banks financial performance.

Ho8: There is no relationship between liquidity position and commercial banks performance

1.4. Scope of the Study

The scope of the study is detained to private commercial banks in Ethiopia that had been in operation for consecutive nine-years (from 2012 to 2020). According to the National Bank of Ethiopia's official website, there were 16 private commercial banks and 2 of the private banks had

not fulfilled the requirement of the study as they had not been operational for the full study period. The dependent variables were delimited to return on asset. The explanatory variables were delimited to board size, independent board directors, number of board committees, frequency of board meetings, board gender diversity, size of audit committee, capital adequacy ratio, liquidity position and the control variables were bank size and banks leverage. The study area of this research was delimited to private commercial banks in Ethiopia.

2. Review of Related Literature

As per Mishkin (2004), a healthy and vibrant economy requires a financial system that moves funds from people who save to people who have productive investment opportunities. The financial system is complex in structure and function throughout the world. It includes many different types of institutions: banks, insurance companies, mutual funds, stock and bond markets, and so on—all of which are regulated by government. Because banking plays such a major role in channeling funds to borrowers with productive investment opportunities, this financial activity is important in ensuring that the financial system and the economy run smoothly and efficiently.

Corporate governance in the banking sector ensures that the values of all stakeholders are protected and also minimizes asymmetric information between bank's managers, owners and customers. Forms of bad corporate governance include official recklessness amongst managers, unethical practices and professional misconduct, insider abuses, poor quality services and weak supervisory structures (Obeten et al. 2014).

According to Berk & Demarzo, (2014) the board of directors delegates most decisions that involve day-to-day running of the corporation to its management. The chief executive officer (CEO) is charged with running the corporation by instituting the rules and policies set by the board of directors. The different stakeholders in a firm all have their own interests. When those interests diverge, we may have agency conflicts.

2.1. Board Size

Board size refers to the number of directors on a board. Different scholars have different conclusions on board size. Board size can have either a positive or negative effect on firm financial performance. According to Alam &Akhter(2017) boards having too many directors could be unproductive with ineffective communication that results directors free riding problem. On the other hand, resource-dependent theory suggests that a larger board allows for more specialists from different fields and therefore facilitates high-quality decision making (Eisenberg et al., 1998 & Kiel & Nicholson, 2003 cited in Salim et al. 2016).

Ho1: There is no significant relationship between board size and commercial banks financial performance.

2.2. Board Independence

The findings made by several researchers on the effect of board independence on firm financial performance were mixed. According to Kumar & Singh (2012) several authors found that the independent directors improve company performance and protect stakeholders in some cases in which there exists an agency problem. On the contrary, using a sample of banking firm data show that board independence is not related to performance (Adams and Mehran, 2012).

Ho2: There is no significant association between independent board directors and commercial banks financial performance.

2.3. Number of board committees

Just like other corporate governance elements, the arguments by several scholars on the effect of number of board committees on banks financial performance were mixed. The board sub-committees are the measurements for better functioning of private commercial banks, as the number of board committees is statistically significant to banks financial performance (Bussoli, 2013). According to Bussoli, Gigante, and Tritto (2015) indicate an insignificant and negative effect of number of board committees on bank performance.

Ho3: There is no relationship between number of board committees and commercial banks financial performance.

2.4. Meeting Frequency of Board

According to different research findings the effect of number of board meetings and banks financial performance show mixed results. As per Akpan (2015), board meetings negatively and significantly related with company financial performance. on the other hand, Fernandes et al. (2017) frequency of board meetings, may indicate an active monitoring role of corporate boards and so, influence banks financial performance.

Ho4 There is a no significance relationship between frequency of board meeting and commercial banks financial performance.

2.5. Board Gender Diversity

In several research findings the effect of board gender diversity on banks financial performance were varied. Some findings were positively affected and others were negatively affected.

Gender diversity is associated with effectiveness in the oversight function of boards of directors which may be more effective if there is gender diversity on board (Boyle and Jane, 2011).Quite the reverse, according to Rose (2007) there is insignificant association between numbers of women directors on the board and firm financial performance.

Ho5: There is no significant association between board gender diversity and commercial banks financial performance.

2.6. Size of Audit Committee

The role of the audit committee, as being to ensure responsible corporate governance by reviewing the firm's financial reporting, providing a channel of communication between the board, external auditors and internal auditors (Liao and Hsu, 2013). Zaman et al. (2011) stated that a positive link between committee size and non-audit service fees. Vafeas and Waegelein (2007) found that AC size was positively associated with audit fee levels. However, while Kent et al. (2010) and Soliman and Ragab (2014) found a significant negative association between the size of the committee and the management of earnings.

Ho6: There is no significance relationship between size of audit committee and commercial banks financial performance.

2.7. Capital Adequacy Ratio

According to Mishkin (2004), bank regulations that restrict bank capital requirements are directed at minimizing moral hazard. Risk-based capital requirement is one form of bank capital requirements. Ongore & Gemechu, (2013) stated that capital adequacy ratio shows the internal strength of the bank

to withstand losses during crisis. The ratio is directly proportional to the resilience of the bank to crisis situations.

Ho7: There is no relationship between capital adequacy ratio and commercial banks financial performance.

2.8. Liquidity Position

Marozva (2015) explained that even if insufficient liquidity is one of the major reasons for bank failures holding liquid assets has an opportunity cost of higher returns. Banks are required to hold a considerable position in liquid assets while on the other hand; they are required to be profitable for them to be sustainable. According to Edem, (2017), the benefits of holding cash are saving of transaction costs to raise funds in which assets are liquidated to make payments and using of liquid assets to finance its activities and investment where other sources of funding are not available or very expensive. Therefore, the dilemma in liquidity management is finding the tradeoff between liquidity and profitability.

Ho8: There is no relationship between liquidity position and commercial banks performance

3. Research Methodology

3.1. Research Design

The research objective of this study was to examine the effect of corporate governance on banks' financial performance. The researcher used quantitative research method to test the hypothesis of causal relationship between the dependent and independent variables.

3.2. Population and Sample

Based on the official website of National Bank of Ethiopia there were 16 private banks operating in the country on the period in which this study conducted. The population of the study is all commercial banks operating in Ethiopia. Purposive sampling technique was used to select the sample commercial banks that have relevant data for the study period.

3.3. Types and Sources of Data

The data for the study was collected from secondary sources. The secondary source of data is the audited financial statements of 14 private commercial banks as a sample over a period of 9 years starting from 2012 to 2020.

3.4. Data Analysis Technique

The study used descriptive data analysis. Pearson correlation analysis had used to identify the relationship among the variables. Multiple linear regression model was used to conduct inferential analysis to determine causal relation of the panel data. The method facilitates statistical testing of hypothesis to help out estimating the dependent variable of bank financial performance based on the different independent variables of corporate governance. SPSS version 23, a statistical software package was used to conduct the statistical analysis.

3.5. Description of Variables and Measurements

Dependent Variable:

Return on Assets (RoA)- It is the variable used to measure bank performance. The ratio reflects the ability of a bank's management to generate profits from assets. It is measured as;

Return on asset (RoA) = $\frac{\text{Profit before tax}}{\text{Average total assets}}$

Board Size: It is a measure of the total number of members serving as board of director.

Independent board members: The ratio of non executive board directors to total board members.

Number of Board Meetings: The count of total board committee and full board meetings held in a year.

Board Gender Diversity: The ratio of female board directors to total board members

Number of Board Sub Committees: Measured as the count of the total number of board sub-committees within the banks.

Audit committee size: Audit committee size refers to the total number of board audit committee members.

Capital Adequacy Ratio

Capital Adequacy Ratio (CAR) = $\frac{\text{Total capital}}{\text{Risk weighted assets}}$

Liquidity Position

Liquidity Ratio = $\frac{\text{Liquid assets}}{\text{Total deposits}}$

3.6. Model specification

To estimate the effect of corporate governance on private commercial bank's financial performance in Ethiopia the following general panel data regression or 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 ROA as dependent Variable is:

$ROAit = \alpha + \beta 1BSZit + \beta 2BIDit + \beta 3NBSCit + \beta 4BMFit + \beta 5BGDit + \beta 6ACSit + \beta 7CARit + \beta 8LPit + \beta 9BSit + \beta 10BLit + \varepsilon_{it}$

4. Results and Discussion

4.1. Descriptive Statistics

Table 4.1 below indicates the descriptive statistics of all variables in the study measured by the mean distribution, standard deviations; minimum and maximum values for the sampled private commercial banks for the period under the study (2012-2020).

Table 4.1

Descriptive Statistics					
Variables	Obs	Minimum	Maximum	Mean	Std. Deviation
ROA	126	.004	.051	.02621	.006572
BS	126	7	13	10.11	1.581
PoFBM	126	0	36	14.86	9.098

PoIBM	126	56	89	75.22	6.541
NoBMPY	126	7	16	11.54	1.760
NoBSC	126	3	6	4.10	1.031
NoAC	126	3	6	4.09	1.088
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

Source: SPSS result

The above Table 4.1 shows the average mean value of ROA of the 14 sample Ethiopian private banks was 2.62%, on average the banks earned 2.62 cents for 1 Birr investment made on assets. The minimum and maximum values were 0.40% and 5.1% respectively. The standard deviation of return on asset is 0.66% from the mean value.

Banks on average had 10.11 board members. They had a minimum of 7 board members and a maximum of 13. Standard deviation of the variable was 1.58 from the mean. The proportion of female board members to total board members indicates a minimum of 0%; to a maximum of 36% composition of females as directors. On average 14.86% of the total board members are female; this indicates that there was low board gender diversity in the Ethiopian private banks. The standard deviation of the variable is 9.098% from the mean value.

The proportion of board members who were independent directors to total members; range from a minimum of 56% to a maximum of 89%. On average 75.22% of the board members were independent directors; this indicates that there was a high percentage of independent board members who had the power to monitor managers. The standard deviation was 6.541% from the mean value.

The average number of board meetings held in a year was 11.54 with a minimum of 7 meetings and maximum of 16. Standard deviation was 1.760 from the mean value. The banks on average, had 4.10 board sub committees, with minimum of 3 board sub committees and a maximum of 6 and standard deviation of the variable of 1.031 from mean value indicates that the range of dispersion of the variable among the banks was low. Concerning to the audit committee size, the sample Ethiopian private commercial banks had a mean value of 4.09 with a minimum of 3 audit committees and a maximum of 6 audit committee members. The standard deviation was 1.088 from the mean value.

The mean value of capital adequacy ratio was 14.6513 %, with minimum value of 7.87%, a ratio just below the minimum statutory requirement of 8% of the National Bank of Ethiopia. The maximum CAR was 25.95% with standard deviation of 3.53117% from the mean value. The mean value of liquidity position of the private banks was 29.6782 %; with minimum and maximum values of 13.00% and 51.43% respectively and standard deviation of 10.61252%. Banks on average had 29.6782% of their deposit in the form of liquid assets. The minimum liquidity ratio requirement of National Bank of Ethiopia is 15%. The average liquidity maintained is well above the minimum required which affects return but also shows strength in meeting obligations.

The descriptive statistics of control variables is also reviewed as follows: The first control variable used was financial leverage which shows the proportion of total amount owed by the commercial banks to total capital. The calculated mean value of financial leverage as control variable was 6.1848 with 1.71855 values deviated from the central point. The difference between mean value and standard deviation indicated the existence of high variation among the sampled commercial banks on their level of financial leverage position. The minimum and maximum values of the variable vary between 1.62 and 11.70 respectively which further showed the variation among target commercial banks in this study. Bank size as measured by the natural log of total assets had a mean value of 10.0428 with minimum and maximum values of 8.63 and 10.95 respectively and standard deviation of 0.46062. Standard deviation of both variables indicated a smaller range of dispersion among the size and indebtedness of the banks.

4.2. Correlation Analysis

Correlation analysis was employed to study the existing linear relationship between corporate governance variables and financial performance indicator on selected private commercial banks in Ethiopia. Correlation analysis allows determining the direction and strength of relationship between variables

Table 4.2

Pearson Correlations

Variables	ROA	BS	PoFM	PoIBM	NoBMPY	NoBSC	NoAC	CAR	LP	BL	BZ
ROA	1										
BS	-.064 (.473)	1									
PoFBM	.020 (.825)	.073 .414	1								
PoIBM	.096 (.284)	.005 .958	.089 .324	1							
NoBMPY	-.165 (.065)	-.013 .884	.026 .769	.094 .293	1						
NoBSC	.094 (.297)	.170 .057	-.086 .337	.092 .306	-.267** .003	1					
NoAC	-.091 (.313)	-.057 .527	-.089 .321	.091 .309	-.008 .928	-.171 .055	1				
CAR	.400** (.000)	.044 .621	.067 .456	.132 .140	-.094 .298	.124 .165	.056 .536	1			
LP	.480** (.000)	-.103 .250	.070 .436	.054 .546	-.265** .003	.068 .449	.039 .667	.454** .000	1		
BL	-.388** (.000	.002 .980	-.068 .447	-.140 .117	.112 .210	-.159 .076	.027 .761	-.935** .000	-.390** .000	1	
BZ	-.303** (.001)	.064 .475	-.188* .035	-.074 .408	.158 .077	.018 .842	-.107 .233	-.640** .000	-.762** .000	.600** .000	1

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

Source: SPSS result

As per the illustration of Table 4.2 capital adequacy ratio, liquidity position, bank leverage and bank size were significantly correlated to ROA at 1% level even though the magnitude of significance varies. Capital adequacy ratio and liquidity position were positively correlated. This signifies that ROA increases as capital adequacy ratio and liquidity position increases. The two controlling variables, bank leverage and bank size were negatively correlated as the effect on the ROA goes in the opposite direction.

As indicated by the correlation result stated in table 4.2 , the Pearson correlation coefficients of board size, female board members, independent board members, frequency of board meetings, number of board sub committees and audit committee size were -6.4 percent, 2 percent, 9.6 percent, -16.5 percent, 9.4 percent, - 9.1 percent respectively. All of these explanatory variables had weak correlation with ROA except for frequency of board meetings.

From correlation matrix, frequency of board meetings was negatively and significantly correlated at 10% confidence level. Both the independent variables of board size and audit committee size negatively and insignificantly affected the ROA. On the other hand, female board members, independent board members and number of board sub committees had an effect on the ROA positively but insignificantly.

4. 3. Regression Results and Discussion

Panel data regression model was conducted to determine the statistical dependence of ROA (dependent variable) on the corporate governance proxies of board size, female board members, independent board members, number of board meetings, number of board subcommittees, audit committee size, capital adequacy ratio and liquidity position.

As it is summarized in the table 4.3 below, the R square for the model was 35%. The adjusted R square, which takes into account the loss of degrees of freedom associated with adding extra variables, was 29%. Adjusted R square implies 29% variability of bank performance measured by ROA can be explained by the explanatory variables of the study.

Table 4.3

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.590[a]	.349	.292	.005530	1.594

a. Predictors: (Constant), BZ, NoBSC, PoIBM, BS, NoAC, PoFBM, NoBMPY, BL, LP, CAR
b. Dependent Variable: ROA

In the table 4.4 below indicated the F statistic of 6.153 was significant with p-value of zero implying that the null hypothesis, that all the coefficients jointly zero were rejected and the model did not suffer from specification bias. P-value less than 0.05 and F statistic greater than zero leads to the null

Table 4.4

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.002	10	.000	6.153	.000[b]
	Residual	.004	115	.000		
	Total	.005	125			

a. Dependent Variable: ROA

b. Predictors: (Constant), BZ, NoBSC, PoIBM, BS, NoAC, PoFBM, NoBMPY, BL, LP, CAR

hypothesis of all factors taken together is approximated by zero is rejected. Hence, all factors (independent variables) taken together can explain the bank financial performance measured by ROA. The variables were jointly significant.

Table 4.5 shows the overall results of regressed variables which indicate the relationship between dependent variables and independent variables. Based on the regression result the corporate governance variables of liquidity position and bank size had statistically positive and significant effect on financial performance of private commercial banks. As a result, based on the statistical findings, the null hypothesis of these variables is rejected and the alternate hypothesis is accepted. This Study also depicted the presences of positive relationship between board independence, capital adequacy ratio and private banks ROA. But the relationship strength was considered to be insignificant.

Board size, frequency of board meetings, number of board sub committees, number of audit committee and bank leverage had all negative and statistically insignificant effect on ROA. Consequently, the null hypothesis that the coefficient of each of all these variables equal to zero cannot be rejected. This implies all these variables do not have any effect on ROA.

Table 4.5 Regression Analysis for the Study Variables

Variables	Coefficient	t-statistic	Sig.
(Constant)	-.045	-1.788	.076
BS	-.036	-.456	.649
PoFBM	.018	.232	.817
PoIBM	.053	.677	.500
NoBMPY	-.042	-.512	.610
NoBSC	-.038	-.453	.651
NoAC	-.085	-1.054	.294
CAR	.187	.800	.425
LP	.628	5.035	.000
BL	-.218	-.954	.342
BZ	.434	3.027	.003

Dependent Variable: ROA[a]

Source: SPSS result, 2022

5. Conclusions and Recommendation

5.1 Conclusions

The main purpose of this study was to examine the effect of corporate governance on financial performance of private commercial banks in Ethiopia.

As per the descriptive statistics, the financial performance of sample private commercial banks was 2.621 percent, as measured by ROA. More than half of the corporate governance mechanisms weakly correlated with the financial performance of sample Ethiopian private commercial banks. All most half of the explanatory variables were strongly correlated with ROA.

The regression analysis depicted a mixed result. Some independent variables such as liquidity position and bank size had positive and significant impact on financial performance and others like board independence and capital adequacy ratio had positive but insignificant effect on ROA. The remaining variables affected ROA negatively and insignificantly.

5.2 Recommendation

On the basis of the empirical findings and conclusions of the study, the following recommendations are forwarded.

- ✓ A considerable attention should be given to the expansion of operations of private commercial banks so as to be benefited by the economies of scale. As the size increases, profitability of banks increases.
- ✓ Commercial banks should maintain the level of liquidity position that helps them to retain the tradeoff between liquidity and profitability. The higher the liquidity position the lower the profitability of the bank and vice versa.
- ✓ The relationship between board independence and financial performances of commercial banks indicated a positive sign. Hence, banks should increase the proportion of independent board members to the total board of directors that improves financial performance.
- ✓ Further research is required due to data considered in the study was only nine years data, sample taken was limited to private commercial banks and all the corporate governance elements were not included in the study. Only some of them were included.

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