# CORPORATE GOVERNANCE AND ITS EFFECTS ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN NEPAL

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**Abstract**

*This current study aims to explore the impact of corporate governance on the financial performance of commercial banks in Nepal. Although there were many researches made on the topic "Impact of Corporate Governance on Financial Performance," However there is only a handful of research found in respect of commercial banks in Nepal. This study tried to fill the gap by studying exclusively in the banking industry of Nepal. The financial performance is measured through Return on assets (ROA) as the dependent variable, and corporate government variables are measured through the percentage of foreign directors in the board, board size, board independence, and board diligence as independent variables. Panel data analysis was used for the study covering the period from 2016/017 to 2020/021 using both descriptive statistic, correlation, multiple regression and t-test to examine the governance practices and their effect in the financial performance of commercial banks in Nepal. The empirical results demonstrated that board diligence (DB) has a positive significant impact on ROA. The result also indicates that there is an insignificant impact of other variables (FD, BI, BS) on ROA of commercial banks in Nepal.*

**Key words**: Corporate governance, board side, board independence, foreign director, board diligence, financial performance, ROA

## INTRODUCTION

Corporate governance refers to the process of making decisions and implementing those decisions into action inlarge corporations. Credibility, openness, and accountability are the three important aspects of corporate governance. The early debates arose in light of the elevation of agency issues come forward due to the separation of "ownership and control," -it was established in the case of Salomon v Salomon *(*Salomon v A Salomon &Co Ltd. [1896] UKHL 1, 1897). The central bank of Nepal released corporate governance guidelines in 2002.Until now, the corporate governance benchmark has been the regulatory standard of Nepal Rastra Bank. There are two notable banking crises in Nepal. One is the financial crisis of Nepal Bangladesh Bank in Nov 2006 (The Himalayan News Service, Nov 12, 2006) and "the Vibor Bikas Bank crisis in 2011 (Sapkota, Manish, 2011)".The central bank had rescued VBB from the crisis.

It is a fact that Nepal Rastra Bank has issued several directives and regulations aimed at improving corporate-governance. Despite the fact, there is still a gap between the policy and its implementation in the Nepalese banking industry.
The Nepalese real estate crisis also highlight show important is the corporate-governance in the banking industry in Nepal (NRB, 2011).

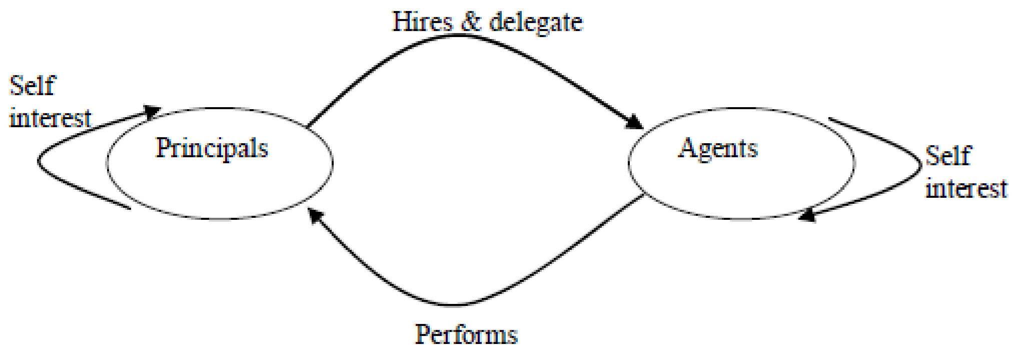
## LITERATURE REVIEW

Both theoretical and empirical literatures are reviewed for the study

### Theoretical Review

The theory discusses the agency problems. The agency problem is a conflict of interest that arises in between the agents and principals in an organization. The theory mainly discusses that a company's owners appoint managers (the agents) to perform the job. The owners expect that the managers would behave and make decisions keeping in view the interests of the owners (the principals). But in practice, generally, the managers are not truly interested in making decisions that are only in the interests of the principals. The agents look for self-interest and also keep opportunistic behavior on many occasions. This theory explains that agents can be guided and could be made responsible by using reward and punishment systems of management.

**Figure:1**




**Source:** Theories of Corporate Governance: Agency, Stewardship etc. https://www.papertyari.com. 19 Aug 2018

**Empirical Literature**

In their study titled "Corporate Governance and banks' productivity: evidence from the banking industry in Bangladesh," Md. Harun Ur Rashid et al. (2020) discovered a positive correlation between corporate governance variables and the financial performance of commercial banks in Bangladesh. Additionally, he found that effective corporate governance helps to strike a balance between the needs of agents (the managers) and owners (the shareholders). Ultimately, it has a positive impact on efficiency. In addition, he discovered that board sizes should be kept as small as feasible because a large board size requires more resources and can reduce the efficiency of banks. Additionally, he discovered that independent directors and board size have no bearing on the efficiency of commercial institutions.

Rudi Zulfikar et al. (2020) discovered in their study titled "Corporate Governance Compliance in Banking Industry: the role of the board" that board size, a high proportion of independent directors, and more frequent board meetings all have a positive impact on improving corporate governance compliances and, consequently, the financial performance of commercial banks in Indonesia. Himal Bhattarai, Dr. Shinu Abhi, and Dr. U.M.Premalatha (2017) discovered in their study titled "Effect of Corporate Governance on the Financial Performance of Banks in Nepal" that bank size and independent directors are highly correlated to the financial performance of commercial banks. Progress Shungu et al. (2014) concluded in their study titled "Impact of Corporate Governance on the Performance of Commercial Banks in Zimbabwe" that board composition and board diversity positively influence banks' financial performance. Similarly, the audit committee and board size have detrimental effects on performance. Ashenafi Beyene Fanta et al. (2013) discovered in their study titled "Corporate Governance and Impact on Bank Performance" that excellent corporate governance always results in improved financial performance for banks. According to the study, board size harms the financial performance of institutions.

**Problem statement**

Regarding economics and government, the 21st century has witnessed more change and volatility than any other era. As competition increases daily, work practices, and principles are steadily evolving, and there have been instances of unethical conduct in an effort to beat the competition. Organizations are globalizing and competition is intensifying. There were also significant drawbacks, such as bank failures, unscrupulous practices, and inefficient organizations. Corporate governance has emerged as a solution to numerous redundancies in financial institutions. The following issues must be addressed in the field of corporate governance.

• The 2007-2008 global financial crisis and the 2007-2009 real estate crisis in Nepal have increased the need for corporate governance in commercial institutions in Nepal.
• In Nepal, very few studies have been conducted in commercial banks' corporate governance.
• The purpose of this research is to determine the present state of corporate governance in Nepalese commercial banks.
• The research will also attempt to establish a connection between corporate governance and the financial performance of commercial institutions in Nepal.

**Objectives of study**

In light of the problem statement, it is essential to determine whether corporate-governance variables affect the financial performance of Nepalese commercial banks. It is also essential to provide stakeholders with a credible recommendation regarding the impact of corporate governance practices on the enhancement of the financial performance of commercial banks in Nepal.

The Central bank's action has strengthened the financial capability and the need for a strong governance system in order to improve performance and protect shareholder interests. Corporate governance is crucial for a developing economy in a Low-Income Country (LIC) such as Nepal. The objectives are detailed below.

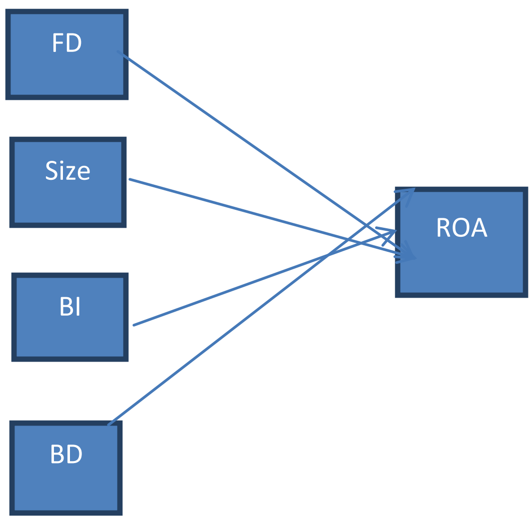
• Evaluate the influence of board size, board independence, board diligence, and foreign directors on the ROA of commercial banks in Nepal.

• Examine the relationship between board size, board independence, board diligence, and foreign directors and ROA in Nepalese commercial banks.

**Conceptual model**

This study has based on Dynamic Panel Data taken from the year 2016-017 to 2020-21 for 5 years. Data have been taken from Annual reports of all the 8 Class “A” commercial Banks of Nepal that are published on Web sites of the concerned commercial banks. Corporate-governance variables are used as used independent variables. ROA has been taken as Dependent variable. Statistical Software Application SPSS has been used to find out correlations among the variables and findthe impact of independent variables upon the dependent’s variables.

**Figure: 2**




**Hypothesis formulation**

Based on research objectives, the following research hypotheses have been formulated.

**H1:** There is a statistically significant impact of board size on ROA of commercial banks of Nepal.

**H2:** There is a statistically significant effect of board independence on the ROA of commercial banks of Nepal.

**H3**: There is a statistically significant influence of board diligence on the ROA of commercial banks of Nepal.

**H4**: There is a statistically significant impact of foreign directors on ROA of commercial banks of Nepal.

## RESEARCH METHODOLOGY

**Research design**

A Descriptive and causal-comparative research design has been used for the research work.

**Population and Sample Size**

Eight commercial banks are taken out of 25 commercial banks as a sample for the study. Independent variables and dependent variables are taken from the websites of the concerned commercial banks of Nepal.

**Data Collection Tools and Process**

Secondary data are collected from the annual report of the websites of concerned commercial banks. The data are taken for five years from the fiscal year 2016-017 to 2020-021. The total number of observations is 40 (8 commercial banks for five years, observations for each). Various statistical tools like Descriptive Statistics, Correlation Analysis, Regression analysis, t-test, are applied using the software application SPSS.

**Regression model**

$ROA^{it} = \alpha_o + \beta 1\ BS^{it} + \beta 2\ BD^{it} + \beta 3\ BI^{it} + \beta 4\ FD^{it} + €^{it}$

Whereas,

$\alpha_o$ = constant

β1, β2, β3 ……. β4 = slope of independent variables

€ = error term

BS = Board Size

BI = Board Independence

BD = Board Diligence

FD = Foreign Director

ROA = Return on Assets

## DATA ANALYSIS AND EMPIRICAL RESULTS

### Descriptive statistics

The descriptive statistics for dependent variable, ROA, and independent variables FD, Size, BI, and BD is described in Table no 1. Mean and standard deviations are used as he descriptive statistics. N represents the no of observations.

**Table: 1**

**Descriptive statistic and Correlations**

| | Mean | S.D. | ROA | FD | Size | BI | BD |
|---|---|---|---|---|---|---|---|
| ROA | 1.662 | 0.466 | 1 | | | | |
| FD | 0.4 | 0.496 | -.331* | 1 | | | |
| Size | 25.59 | 0.336 | -.172 | .309 | 1 | | |
| BI | 12.8 | 6.448 | -.020 | .176 | .203 | 1 | |
| BD | 16.03 | 5.894 | .308 | -.091 | .367* | -.038 | 1 |

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

The relationship between corporate governance and the profitability of commercial banks in Nepal is illustrated in Table 1. ROA has a mean value of 1.662% and a standard deviation of 0.466%. FD has a mean value of 0.40 and a standard deviation of 0.496%. The mean size value is 25.59, and the standard deviation is 0.336. BI has a mean value of 12.80 and a standard deviation of 6.448. BD has a mean value of 16.03 and a standard deviation of 5.894.

### Regression Evaluation

Al-Matari et al.,2012;Al-Sahafi et al.,2015; Farhan et al.,2017;Naushad & Malik,2015) examined the relationship between corporate governance and firm performance using a technique of multiple regression utilized by numerous researchers. According to Hutcheson and Sofroniou (1999), OLS is an appropriate statistical technique when the regression model contains continuous and dummy variables- testing the relationship between corporate governance variables and then financial performance of commercial banks in Nepal using OLS regression.

**Table: 2**
**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .488[a] | .238 | .151 | .42942 |

Predictors: (Constant), BD, BI, FD, Size

**Regression results – Dependent variable – ROA**

**Table: 3**
**Coefficients**

| Model | Un standardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (Constant) | 10.387 | 6.034 | | 1.721 | .094 |
| FD | -.217 | .151 | -.231 | -1.441 | .158 |
| Size | -.360 | .241 | -.260 | -1.494 | .144 |
| BI | .006 | .011 | .088 | .577 | .568 |
| BD | .030 | .013 | .385 | 2.351 | .025 |

The results of the financial performance of commercial banks in Nepal using ROA as the dependent variable are presented in Table 2. The table indicates that board diligence (BD) was statistically significant concerning ROA at the 5% level. The result shows that an increase in the number of board meetings (BD) could promote more diverse ideas regularly, resulting in an increase in ROA due to improved decisions.

## CONCLUSION

This study investigated the connection between corporate governance variables (Foreign Director, Board Size, Board Independence, and Board Diligence) and the financial performance of commercial banks in Nepal. Few studies have been conducted in corporate governance, especially in the financial industry, which prompted this study. This study contributes to the literature on the significance of corporate governance in Nepal's financial sector. The study's findings do not corroborate all proposed hypotheses. The government, the capital market authority, commercial banks, and other financial institutions may benefit from this study. This study could also serve as a source of inspiration for economic sectors, such as financial services, insurance, and so on. Using ROA as the dependent variable, the financial performance of commercial banks in Nepal was determined. The table indicates that board diligence (BD) was statistically significant with respect to ROA at the 5% level. The result shows that an increase in the number of board meetings (BD) could promote more diverse ideas on a regular basis, resulting in an increase in ROA due to improved decisions.

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