The Effect of Corporate Governance Mechanisms and Bank-Specific Factors on the Financial Performance of Commercial Banks in Nepal

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Abstract

This study investigates the impact of corporate governance mechanisms and bank-specific factors on the financial performance of Nepalese commercial banks. The research examines five banks from 2016/17 to 2022/23, focusing on two corporate governance mechanisms—board size and capital adequacy ratio—and three bank-specific factors: dividend payout ratio, firm size, and non-performing loan ratio. Data for the study were gathered from secondary sources, including publications and annual reports of banks listed on the Nepal Stock Exchange (NEPSE). A purposive sampling method was used to select five merged banks for analysis. Descriptive analysis, Pearson correlation, and multiple regression models were employed to assess the relationships between the variables and the return on assets (ROA), which served as the dependent variable. The findings indicate that board size positively and significantly affects ROA, while firm size has a significant negative impact. However, capital adequacy ratio, dividend payout ratio, and non-performing loan ratio do not show significant effects on ROA. Thus, the study offers valuable insights for regulators, managers, depositors, and other stakeholders, contributing to improved performance and profitability of integrated commercial banks in Nepal.

Keywords: *Corporate governance mechanism, Bank specific factors, Return on assets, Board size, Non-performing loan ratio*

1. Introduction

Banks have a crucial role in the economic growth of nations as they have significant control over the flow of money in circulation and are the primary drivers of economic progress. (Memmel & Raupach, 2010). Thus it is regarded as the fundamental pillar of a country's economy. It serves as the vital force driving global trade and e-commerce, since banks play a crucial role in providing financial resources for economic transactions. The increasing globalisation and its impact on the development and distribution of products and services globally, while also adapting to local markets, has made it imperative for multinational banks and the local banking system of developing countries like Nepal to have an efficient banking system.

In order to grow and expand sustainably, financial institutions must turn a profit. Numerous internal (bank-specific) and external (macroeconomic) factors impact banks' profitability. Most studies divide the variables that affect commercial banks' bottom lines into two categories: those that are internal, or endogenous, and those that are external, or exogenous (Khrawish, 2011). A number of factors are considered internal variables, including capital adequacy, loans, deposits, foreign ownership, administrative costs, and off-balance sheet operations. Al-Harbi (2019) argues that variables such as GDP growth, GDP per capita, real interest rate, regulations, and financial structure are examples of external influences. The effect of bank-specific variables on the financial outcomes of five commercial banks that have recently amalgamated is examined in this study. Considerations unique to banks were included in the research, which included firm size, capital adequacy ratio, liquidity, non-performing loan ratio, and dividend payout ratio. Return on assets was used to assess the performance of banks in Nepal.

2. Objective of the Study

The main objective of the study is to examine influence of corporate governance mechanisms and bank-specific factors on financial performance of commercial banks in Nepal.

3. Literature Review

The banking industry is widely recognised as the central component of the financial system, playing a crucial role in attracting deposits, providing credit to borrowers, offering various services to clients, and fostering economic growth. Financial performance is an evaluation carried out to assess the

degree to which a company has effectively and accurately implemented financial practices in accordance with established regulations. The majority of past research have focused on identifying specific characteristics that impact bank performance, particularly in relation to their influence on profitability. Nevertheless, this study is focusing on financial performance indicators, including board size, capital adequacy ratio, dividend payout ratio, firm size and non-performing loan ratio. The aforementioned research might serve as a crucial resource in bolstering the findings of this article. Ajola et al. (2012) investigated how corporate governance influences the performance of the Nigerian banking sector by employing Pearson Correlation and Regression analyses. Their study revealed a significant negative relationship between board size and the financial performance of selected banks over a five-year period. Similarly, Bawa and Lubabah (2013) researched the connection between corporate governance and the financial performance of twelve Nigerian banks from 2006 to 2010, and they too found a negative relationship between board size and bank profitability. In contrast, Akpan and Rima (2012), using linear regression analysis on eleven selected Nigerian banks, along with Asuagwu (2013), concluded that a smaller board size significantly and positively improves performance.

Batten and Vo (2019) used a variety of econometric panel data methods on a sample that spanned 2006–2014 to investigate whether variables impact bank profitability in Vietnam. Operating expenditures, capital, and the size of the bank all have a significant role in determining the bank's profitability, they found. To determine the effects of macroeconomic forces and bank-specific variables on Saudi Arabian regional banks, Shamim et al. (2018) conducted a study. The findings show that operational efficiency, bank size, liquidity, and credit risk were the most important internal determinants influencing bank profitability. Menicucci and Paolucci (2016), examined 35 of Europe's most prominent banks to see which variables were associated with profitability. All of the model's factors had a substantial effect on banks' bottom lines, according to the results. The capital ratio and bank size were shown to be significantly and positively associated with profitability, nevertheless. Similarly, Rahman et al. (2015) looked at what made a difference to the profitability of Bangladeshi banks. The results indicated that the return on assets was positively and significantly affected by the size of the bank. Nguyen et al. (2020) examined how government ability and bank-specific variables affect Vietnamese banking profitability. The study uses fixed, random effects, and pooled ordinary least squares to examine panel data from 2014-2018. The study found no statistical influence on ROA

from bank-specific characteristics including CAR, CER, and SIZE. The capacity of a bank to withstand unforeseen financial difficulties is referred to as "capital adequacy" (Kosmidou, 2008). Strict rules govern the capital structures of banks. This is because capital plays a crucial role in reducing the likelihood of bank collapses and the harm that depositors endure when such a catastrophe occurs. This is due to the fact that heavily indebted businesses are prone to taking unnecessary risks in pursuit of higher shareholder profits, which in turn hurt their lenders (Kamau, 2009) on their analysis of listed banks on the Indonesian stock exchange from 2008 to 2012, Lukas and Basuki (2015) concluded that the capital adequacy ratio had no meaningful relationship with the performance of these institutions. Return on assets and return on equity, two measures of a bank's performance, are positively correlated with the capital adequacy ratio, according to research by Kanojia and Priya (2016), which covers the years 2008-09 to 2011-12 and involves 40 banks.

Ouma (2012) conducted an in-depth study from 2002 to 2010 using regression analysis to examine the relationship between dividend payout ratios and the success of listed corporations in the Nairobi Stock Market. The findings revealed a strong positive correlation, emphasizing the importance of dividend policy as a strategic financial decision. Research on deposit money banks in Nigeria found, by the use of multiple regressions and correlation analysis, dividend payout ratio was negatively correlated with performance (Yusuf, 2015). The correlation between ROA, nonperforming loan ratio, and liquidity ratio is negative and statistically significant. Enekwe et al. (2015) examined how dividend distribution affected listed cement firms' performance in Nigeria from 2003 to 2014. Return on capital employed, return on assets, and return on equity measure performance, whereas dividend payout ratio measures independent variable. Secondary data collected from Nigerian Stock Exchange. Ordinary least squares panel estimation, descriptive research, and basic linear regression are used for data analysis. The researchers' empirical results suggest that dividend payout ratio has a positive relationship with all the dependent variables: return on capital employed, return on assets, and return on equity used for this study. Dividend payout ratio is statistically significant with return on capital employed and return on asset, but not with return on equity of quoted cement companies in Nigeria. Lee and Iqbal (2018), studied that economic actions of a bank affect the economy of a country. Banking profitability affects a nation's health. The authors examined bank-specific and macroeconomic factors affecting bank activity. Data was obtained from 23 banks from 2009 to 2016. ROA and ROE were positively affected by interest margin, capital adequacy ratio, and loan to deposit

ratio. Ullah, Nath, & Biswas (2020) examined how bank-specific internal variables affected five Bangladeshi state-owned commercial banks' profitability. The results found the negative correlation between ROA and NPLR. A negative association was established between return on asset (ROA) and investment deposit ratio (IDR), whereas bank size and ROA were positive. A statistically negligible link exists between debt to equity and equity to asset ratios and return on asset. The study found that among these five banks, non-performing loans, bank size, and liquidity are the most critical determinants affecting profitability. Alshatti (2016) aims to uncover the key factors that determine the profitability of banks in Jordan. The author utilizes a panel data set consisting of thirteen banks from the years 2005 to 2014.The study employed return on equity and return on assets as indicators of profitability. It discovered that capital adequacy, capital, and leverage positively influence profitability, whereas asset quality had a negative impact on profitability. Ekinci and Poyraz (2019) analyzed the data from 26 Turkish banks between 2005 and 2017 to analyze how credit risk affects bank efficiency. According to the findings, Non-Performing Loans (NPLs) have a negative relationship with Return on Assets. The findings showed that non-performing loans, the loan-to-deposit ratio, and loan loss reserves are the main bank-specific variables that substantially affect bank efficiency. Banks with greater loan-to-deposit ratios are more likely to be successful. Negative effects on efficiency are associated with both risk and the amount of non-performing loans a bank has active (Nguyen et.al., 2020).

Ullah et al. (2020) investigated the bank-specific internal variables that impact the profitability of state-owned commercial banks in Bangladesh. The study used an explanatory research methodology and relied solely on secondary data. The major source of data are the different banks' annual reports from 2014 to 2018. Multiple regression model and descriptive. Statistics are employed in data analysis. The results show that there is a significant and negative relationship between non-performing loan ratio and ROA. On the other hand, bank size has significant positive impact on ROA. According to Pradhan (2016), who examined 22 Nepalese commercial banks between 2005/06 and 2011/12, macroeconomic indicators like GDP and inflation didn't matter. Therefore, it cannot be concluded that external influences have an effect on the performance of banks. On the other hand, bank performance is greatly impacted by characteristics that are unique to each bank. Return on assets (ROA) is considerably affected by bank size, liquidity, and management, but capital sufficiency is unaffected, according to Lunga (2014), who studied twelve banks in Malawi between 2009 and 2012. Similarly, earning yield is highly affected by bank size, capital sufficiency, and management

effectiveness, although liquidity has a little role. Between 2010 and 2015, Yakubu (2016) used the ordinary least square approach to study five different commercial banks in Ghana. Size, liquidity, and expenditure management are three of the author's listed bank-specific characteristics that have a major impact on bank profitability. On the other hand, academics have paid less attention to how commercial banks in Nepal's profitability is affected by internal characteristics that are specific to each bank.

4. Research Methodology

The research methodology adopted in this study plays a crucial role in shaping the objectives, findings, and presentation of outcomes derived from the gathered data. The study's fundamental data are sourced from secondary outlets like publications and the annual reports of commercial banks listed on the Nepal Stock Exchange (NEPSE). This study employed a non-probability sampling approach, specifically utilizing the purposive sampling method. The study's sample was collected during the years 2016/7 to 2022/23. From a group of twenty operating commercial banks, five merged, NIC Asia Bank Limited, Kumari Bank Limited, Himalayan Bank Limited, Prabhu Bank Limited, and Prime Commercial Bank, were selected to be included in the study for a period of ten years. Return on asset as a measure of performance, serving as the dependent variable and corporate governance mechanism factors such as board size and capital adequacy ratio, alongside bank-specific factors like dividend payout ratio and firm size and non-performing loan ratio, were considered as independent variables. To analyze the collected data, the study utilized a combination of descriptive analysis, Pearson correlation, and regression analysis. Descriptive analysis provided a comprehensive overview of the data, while Pearson correlation helped identify potential relationships between variables. Multiple linear regression analysis, on the other hand, allowed for a deeper exploration of the relationships between the independent and dependent variables, helping to assess the impact of corporate governance and bank-specific factors on performance measures.

Model:

ROA ***(financial performance) = β_0 +β_1 (BSIZE) + β_2(CAR) + β_3 (DPR)+ β_4, (FSIZE)+ β_5 (*****NPLR) + ε_i***

(where ROA = Return on Asset; BSIZE = Board size; CAR = Capital adequacy ratio; DPR = Divined Payout Ratio; FSIZE = Firm size; NPLR = Non- performing loan ratio; β_0 = Constant; β_1, β_2, β_3, β_4, β_5 = Coefficient of Independent Variables; and ε_i = Error term.)

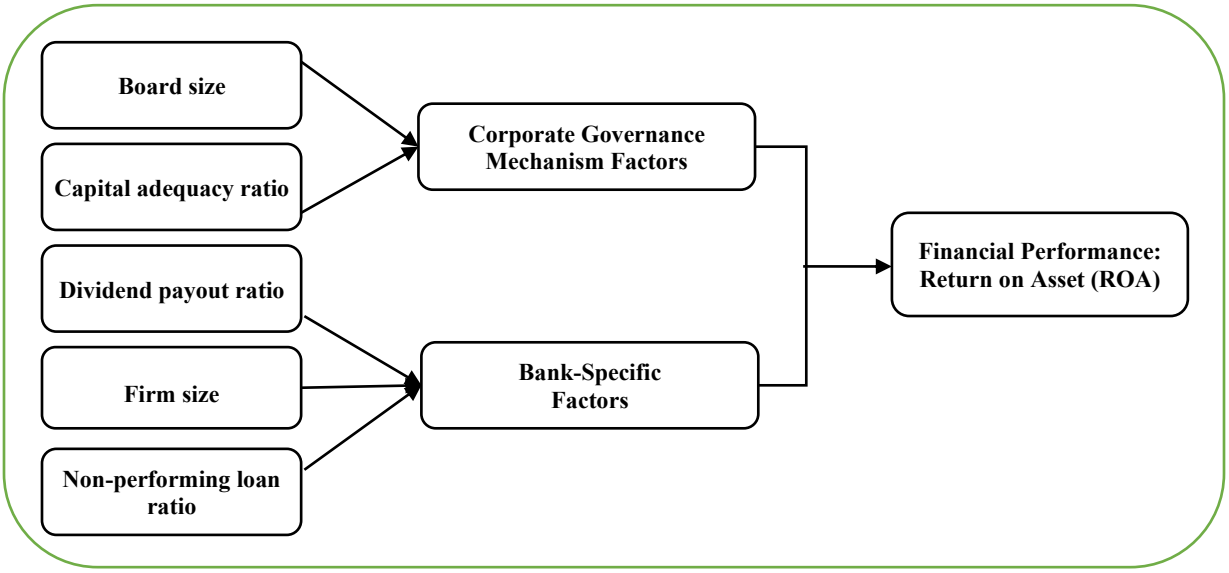

Figure 1. Conceptual framework

(Source: Conceptual model developed by author)

Dependent and Independent Variables

Table 1: Definition and Measurement of Variables

SN	Types	Name of variables	Measurement
1	Independent variables (Internal factors)	Bank size (BS)	Natural logarithm of assets
		Capital adequacy ratio (CAR)	(Tier 1 capital + Tier 2 capital) / Risk weighted Assets
		Non-performing loans ratio (NPLR)	NPLs / Total Loans
		Board size(BS)	Total number of members serving on a firm's board.
		Dividend payout ratio (DPR)	Dividend/Net Income
2	Dependent variable (Profitability)	Return on assets (ROA)	Net income / Assets

Research Hypothesis

The investigation is based on five hypotheses. If the estimated coefficient is statistically significant and has the same sign as our expectation, then we may say that the hypothesis deserves to be accepted. In the event if the predicted coefficient is just slightly less than the expected value, but the sign is as anticipated, it will be somewhat reasonable. Unless this condition is met, the hypothesis will be rejected. Specifically, Hassan and Ahmed (2019).

H_1: Bank size has a significant positive impact on the banks' profitability.

H_2: Capital adequacy ratio has a significant positive impact on the banks' profitability.

H_3: Dividend payout ratio has a significant positive impact on the banks' profitability.

H_4: Firm size has a significant negative impact on the banks' profitability.

H_5: Non-performing loans ratio has a significant negative impact on the banks' profitability.

5. Results and Discussion

Table 2 presents the descriptive statistics for six variables based on a sample size of 30. the variables include board size, capital adequacy ratio, dividend payout ratio, firm size, non-performing loan ratio, and return on assets. The Board Size ranges from 5 to 8, with an average of 7.10 and a standard deviation of 1.155, indicating moderate variability. The distribution is negatively skewed with a skewness of -0.926 and has a kurtosis of -0.666, suggesting a flatter distribution than normal. The Capital Adequacy Ratio varies from 11.16 to 14.89, with a mean of 12.8937 and a standard deviation of 1.00462, and exhibits a nearly symmetrical distribution with a skewness of 0.046 and a kurtosis of -0.478. The Dividend Payout Ratio (DPR) shows substantial variability, ranging from 0.00 to 31.60, with a mean of 3.7195 and a high standard deviation of 6.55840. It is highly positively skewed (2.975) and leptokurtic (10.882), indicating many extreme values. Firm Size (FS) ranges from 24.34 to 26.61, averaging 25.4136 with a standard deviation of 0.63368, and displays a slight positive skewness (0.210) and a kurtosis of -0.517. The Non-Performing Loan Ratio (NPLR) ranges from 0.06 to 4.55, with a mean of 1.4147 and a standard deviation of 1.09022, showing a positive skewness (1.653) and a leptokurtic distribution (2.294). Lastly, the Return on Assets(ROA) varies from 0.71 to 2.21, with an average of 1.3927 and a standard deviation of 0.43325. Its distribution is slightly positively skewed (0.263) and platykurtic (-0.804). These statistics provide an overview of the central tendency, variability, and distribution shape for each variable.

Table 2: Descriptive Statistics (N = 30)

	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
BS	5	8	7.10	1.155	-0.926	-0.666
CAR	11.16	14.89	12.8937	1.00462	0.046	-0.478
DPR	0.00	31.60	3.7195	6.55840	2.975	10.882
FS	24.34	26.61	25.4136	0.63368	0.210	-0.517
NPLR	0.06	4.55	1.4147	1.09022	1.653	2.294
ROA	0.71	2.21	1.3927	0.43325	0.263	-0.804

Table 3 presents the summary statistics for a regression model. The model's correlation coefficient (R) is 0.623, indicating a moderate positive relationship between the observed and predicted values. The R Square value of 0.389 means that 38.9% of the variability in the dependent variable is explained by the independent variables in the model. The Adjusted R Square, which adjusts for the number of predictors, is 0.261, providing a more accurate measure of the model's explanatory power when multiple predictors are included. The standard error of the estimate is 0.37241, representing the average distance that the observed values fall from the regression line. The Durbin-Watson statistic is 1.992, which is close to 2, suggesting that there is no significant autocorrelation in the residuals of the model.

Table 3: Model Summary of Return on Assets

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.623	0.389	0.261	0.37241	1.992

Table 4 presents the ANOVA (Analysis of Variance) results for a regression model predicting the dependent variable, Return on Assets (ROA). The regression model explains a sum of squares of 2.115, distributed over 5 degrees of freedom (df), yielding a mean square of 0.423. The residual sum of squares, representing the unexplained variance, is 3.329 with 24 degrees of freedom, resulting in a mean square of 0.139. The total sum of squares, combining both regression and residual variances, is 5.443 with 29 degrees of freedom. The F-statistic, calculated as the ratio of the mean square of the regression to the mean square of the residual, is 3.050. This F value, with a significance level (Sig.) of 0.029, indicates that the regression model is statistically significant at the 5% level.

Table 4: ANOVA for Return on Assets

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	2.115	5	0.423	3.050	.029[b]
	Residual	3.329	24	0.139		
	Total	5.443	29			

Table 5 displays the results of a regression study that found many relevant factors that predicted ROA. Board Size has a positive and significant effect on ROA, with a coefficient of 0.162, a standard error of 0.061, a t-value of 2.649, and a p-value of 0.014. So the alternative hypothesis (H1) is accepted. In other words, board size has substantial impact on ROA This results is similar to Akpan and Rima (2012) and Asuagwu (2013). Capital Adequacy Ratio has an unstandardized coefficient of -0.030 and beta is -0.069, with a t-value of -0.336 and a significance level of 0.740. So the alternative hypothesis (H2) is rejected. In other words, capital adequacy ratio has no impact on ROA. This observation is similar to Nguyen et al. (2020) examined the banking sector in Vietnam. The dividend payout ratio has a standard error of 0.012 and an unstandardized coefficient of 0.011. The Beta value is 0.161, with a t-value of 0.918 and a significance level of 0.368, suggesting that there is no significant relationship with ROA. Therefore, the alternative hypothesis (H3) is rejected. It suggests that ROA is not influenced by the dividend payout ratio of the banks. This observation differs from the one presented by Enekwe et al. (2015), who examined the impact of dividend payouts on the performance evaluation of publicly traded companies. Firm size has an unstandardized coefficient of -0.307 with a standard error of 0.114. The Beta coefficient is -0.449, with a t-value of -2.692 and a significance level of 0.013, indicating a significant but negative relationship with ROA. So the alternative hypothesis (H4) is accepted. This study differs with Ullah et al.'s (2020) findings in that it demonstrates a positive significant influence on ROA of Bangladesh's state-owned commercial banks. On-performing loan ratio has an unstandardized coefficient of -0.122 and a standard error of 0.086. The Beta is -0.308, with a t-value of -1.430 and a significance level of 0.166. So the alternative hypothesis (H5) is rejected. It indicates that non-performing loan ratio has not effect on ROA. This finding is in contrast to the findings of Ullah et al. (2020), who conducted an investigation into the profitability and bank-specific internal variables of state-owned commercial banks in Bangladesh. The collinearity statistics show tolerance values and Variance Inflation Factors (VIF) within acceptable ranges, indicating that multicollinearity is not a significant issue in this model. overall, the results highlight that board size and firm size are significant predictors of ROA, while the other variables are not.

Table 5: Coefficients of Independent Variables

Model		Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
		B	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	8.564	3.194		2.681	0.013		
	BS	0.162	0.061	0.432	2.649	0.014	0.959	1.042
	CAR	-0.030	0.088	-0.069	-0.336	0.740	0.606	1.650
	DPR	0.011	0.012	0.161	0.918	0.368	0.826	1.211
	FS	-0.307	0.114	-0.449	-2.692	0.013	0.915	1.093
	NPLR	-0.122	0.086	-0.308	-1.430	0.166	0.550	1.819

Dependent Variable: ROA

6. Conclusion

The study aims to determine the impact of corporate governance mechanism and bank specific factors on financial performance of Nepalese banks. This research examined five Nepalese commercial banks' performance from 2016/7 to 2022/23. The analysis considers two corporate governance mechanism factors, namely board size and capital adequacy ratio, along with bank-specific factors like dividend payout ratio, firm size, and non-performing loan ratio of the commercial banks. The research used descriptive and multiple regression model analysis to investigate the influence of profitability of the banks. The findings result show that board size has a positive and significant effect on ROA, firm size shows a significant negative relationship with ROA. The remaining predictors, including capital adequacy ratio, dividend payout ratio, and non-performing loan ratio do not show significant impacts on ROA. The research did not incorporate any macroeconomic variables that may potentially impact the profitability of commercial banks. Therefore, further research on the commercial banks in Nepal is necessary. Nevertheless, the author asserts that this study will improve performance by offering regulators, managers, depositors, and other stakeholders useful insights into the profitability of integrated commercial banks.

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