PressAcademia
www.pressacademia.org/conferences

IFC
ISBN 978-605-06192-1-8

PressAcademia Procedia YEAR 2020 VOLUME 12

Istanbul Finance Congress, November 5-6, 2020

THE INTERACTION BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: AN IMPLEMENTATION FOR THE UK BANKS

DOI: 10.17261/Pressacademia.2020.1350
PAP- V.12-2020(14)-p.64-69.

Ibrahim Almusattar, Dilek Teker
Okan University, Social Sciences Institute, Istanbul, Turkey.
almusattar@stu.okan.edu.tr, ORCID: 0000-0002-3782-1019
Işık University, Department of Business, Istanbul, Turkey.
dilek.teker@isikun.edu.tr, ORCID: 0000-0002-3893-4015

To cite this document
Almusattar, I., Teker, D., (2020). The interaction between corporate governance and financial performance: an implementation for the UK banks. PressAcademia Procedia (PAP), V.12, p.64-69.
Permanent link to this document: http://doi.org/10.17261/Pressacademia.2020.1350

ABSTRACT
Purpose- The purpose of this study is to examine the relationship between the performance of commercial banks with corporate governance elements. Thus, the listed commercial banks in the London Stock Exchange (LSE) of the UK will be considered in this study. Hence, using availability data of the Financial Times Stock Exchange 100 (FTSE 100) companies including banks that operate in LSE, the period (2010-2019).
Methodology- The study employs a sample of 10 biggest banks trading on (LSE) ranked by market capitalization as of December 31st. 2019. The study will use panel data method and the results will be analysed by descriptive statistics, correlation, and regression. Seven major corporate governance variables will be analysed within the framework of corporate governance theory namely: Board Size, Board Independent, Foreign owners, bank ownership structure, Audit Committee, Female Board, Financial Leverage, and board size and their impact on the financial performance of the commercial bank in the UK which will be measured using Return on Assets Ratio (ROA), Return on Equity (ROE), and The TOBIN's Q.
Finding- The analysis of previous studies reveals that internal corporate governance mechanism (Board of Director's) has significant impact on the performance of banks such as Tamer Shahwan (2014).
Conclusion- This study will investigate the relationship between CG (Board Characteristics, Audit committee, Owners structure, and banks size and financial leverage) and banks performance which will measured by (ROA, ROE, and TOBIN; Q).

Keywords: Corporate governance, board of directors' characteristics, audit committee characteristics, ownership structure, bank performance.
JEL Codes: M40, M41

1. INTRODUCTION

Corporate governance has become one of the most topical issues in the modern business world today and has appeared to assist both management and shareholders of various finance and non-finance enterprises. According to Choudhury & Alam (2013), corporate governance is the relationship between corporate management, executives, the providers of equity, and people and institutions who save and invest their money to get a return. Corporate governance ensures that the board of directors is responsible for the pursuit of corporate an aim and that the enterprises conform to the rules and regulations. Reddy et al (2013) claimed that good corporate governance system allows companies to have easier access to resources, lower costs of capital, enhance stakeholder reputation and improve organisational performance. Cadbury (1992) stated that corporate governance concerned with the duties and responsibilities of an enterprise's board of directors to successfully guide it. Moreover, the report is concerned with the relationship between shareholders and other stakeholder groups. Furthermore, the report defines corporate governance, as 'the system by which companies are directed and controlled. Therefore, this widely accepted definition identifies management accountability to shareholders. https://www.frc.org.uk/.

2. LITERATURE REVIEW

In the literature, the concept of corporate governance defined as 'corporate governance is the system by which companies are directed and controlled'. This is widely accepted definition by Sir Arthur Cadbury's (Cadbury 1992) and clearly identifies the management accountability to shareholders. https://www.frc.org.uk/.

Furthermore, OECD in 2001 has published a broader definition of corporate governance "Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other, this definition indicates that corporate governance means establishing a set of rules and actions that facilitate the shareholders decision making process. http://www.oecd.org/.

Makki and Lodhi(2013) agreed that the aim of corporate governors is to gain competitive benefit in a free market knowledge economy. This competitive edge is possible if Corporate governance enhances value through exploiting all available resources. Good Corporate governance practices ensure better decision making, operational efficiency, and reduction in wastes. It further balances the interests of all stake holders including executives and non-executive. Shareholders can believe that companies with good Corporate governance practices make sure that free cash flow should be returned to shareholders as dividend rather than being expropriated by the insiders.

What is More, Asma'a Al-Amarneh(2014) referred that Corporate governance is needed because of the existence of agency problems caused by the separation of ownership of resources and managing those resources. Good Corporate Governance practice is one mechanism used to minimize the conflict of interest between agents (management) and principals (shareholders). Since the bank sector is the most important sector in any economy, it is critical for economic growth and development; hence, there is a need for its strict regulation all over the world.

On the other hand, many researchers believes that companies with weak corporate governance may confront sustainability problems in highly competitive markets and as well as increase the level of agency problem between executive and shareholders. Additionally, according to Makki & Lodhi(2013) poorly governed firms have lower operating performance while good governed firms demonstrate higher financial performance and market firms with good corporate governance practices not only grant more cash dividend but also more rights to its shareholders.

2.1.Theoretical Perspective of Corporate Governance

There are underlying theories pertaining to corporate governance relation between the owner and manager to reduce the conflict of interest between two parties such as:

Agency theory- Identifies the agency relationship between the shareholder or (principal) and the manager or (agent). Managers are appointed by shareholders to manage and run the business to achieve company's goal which is shareholders' wealth maximisation. However, agency theory pinpoints the problems of goal incongruence between managers and shareholders whereby the managers may act in their personal interests by pursuing prerequisites and power. Pande & Ansari (2014).

Stewardship theory- While Agency theory assumes that principals and agents have divergent interests and that agents are essentially self-serving and self-centred, Stewardship theory takes a diametrically opposite perspective It suggests that the agents (directors and managers) are essentially trustworthy and good stewards of the resources entrusted to them, which makes monitoring redundant. Bathula, H. (2008).

Stakeholder Theory- The theory of stakeholder suggests management to take care of the development of all stakeholder relationships, and not concentration only on shareholders' interests. Therefore, the new performance of companies is to focus on society as a whole which be different from the objective of companies to maximise shareholder's wealth. Bouheni, & Levy (2016).

2.2. Differences in Corporate Governance for Banks

Oskar Kowalewski (2008) believes that the board of director's role is to drive firms in safe way, define the strategic plan, and review the company's performance and risk management. There are many debates about the role boards of director's play, as they are essential to the success of the company. The role of chairman is also very important because it connects the board with management.

According to Andy Mullineux (2006) the banking system and financial market have been changed and developed in order to spurs economic growth. Moreover, the corporate governance plays major roles in banking system as good bank regulation and control become part of corporate governance system. In addition, good corporate governance structure of banks needs a good risk related prudential regulation, pay more attention to conflicts of interest (agency problem) and competition issue, particularly given the clear information that advantage of banks over their retail customers.

2.3. Corporate Governance and Bank Performance

The firm's performance is directly affected by the performance of the board of directors (BOD). Thus, the (BOD) can be more effective if they understand the procedure of work which has the linkage between the (BOD) outputs and firm performance. Murphy & Mclntyre (2008). Directors assistance determine the strategic direction of a business and are accountable for ensuring the organisation has a good Mehrotra, S,2016, and Embi, & Ismail, 2016). scheme of internal control. (Javed, & Malik, 2013, Boussaada, & Karmani,2015,

3.METHODOLOGY

Defines research methodology as the adoption of a scientific approach to collect data in order to respond to a research query and meet a research objective.

3.1. Bank Performance Measurement

Banks performance in the corporate governance literature is based on the financial indicators and banks value. There are many measures of banks performance, therefore, this research will use three set of financial measures of banks performance as accounting-based and market-based measures. Most commonly used accounting-based measures are return on assets (ROA), return on equity (ROE) and The TOBIN's Q.

Return on Assets (ROA) measure performance which is widely used in the literature and highly representative as an accounting-based measure. It shows the efficiency of assets employed. ROA shows the earnings that banks have generated from their investments in capital assets. Since managers are responsible for the operation of the business and utilization of the bank's assets, ROA is a measure that allows users to assess how well a bank's corporate governance system is working in securing and motivating efficiency of the banks management. ROA is calculated as net income divided by total assets.

Return on Equity (ROE), is another important measure of banks performance used in corporate governance studies. The primary aim of the banks is to make profit. Return on equity is the most acceptable ratio in order to measure profit. It is defined as the net income divided by common equity. Mirchandani & Gupta (2018) state that ROE is another accounting-based performance measure widely used in corporate governance research. It is a measure that shows the profit generated from the money invested by the shareholders. ROE is calculated by dividing net income by common equity

Naushad & Malik (2015) state the performance measure, that we use in the study by considering the financial aspect. The TOBIN's Q is denoted as the proxy for it. TOBIN's Q propounded by James C. Tobin (1969) explains the relationship of current cost of replacement assets to the market value of the firm's assets including share & stocks. Tobin's Q is a market-based measure of profitability widely used in corporate governance studies as a proxy for firm performance. It is defined as the ratio of the market value of assets to the replacement value of assets which shows the financial strength of a company. Bhagat & Jefferis (2002).

3.2. Hypotheses

Corporate governance of banks is principally complex, as these financial institutions are unique and differ basically from non-financial institutions. Indeed, corporate governance of banks plays an important role due to the distinctiveness of these institutions. Banks being the right arm of the economy, its corporate governance is a challenging subject.

Board Size and Banks Performance

Salim et al. (2016) agree that board size can have either a positive or negative effect on corporation performance. On one hand, a large board makes coordination and communication difficult, allowing the CEO to gain control over the board, triggering the agency issue and reducing company performance. 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. Further, more board members can provide additional networking to allow acquisition of key external resources.

H0: There is a positive or a negative relationship between Board size and bank performance in the UK.

H1: There is no a positive or a negative relationship between Board size and bank performance in the UK.

Board Independence and Banks Performance

According to Hoti & Dermaku (2018) a greater number of independent board members have an impact on improving the board's objectivity and its ability to present some views on various issues.

H0: There is a positive or a negative relationship between Board independent and bank performance in the UK.

H2: There is no a positive or a negative relationship between Board independent and bank performance in the UK.

Foreign Ownership and Banks Performance

Asma'a Al-Amarneh (2014) cites that international ownership is another factor that can lead to differences in organizational objectives, practices, and governance mechanisms. If foreign investors hold a large portion of shares of a corporation, a signal will be sent to all other participant in the market that foreign investors have a high confidence in these companies. Accordingly, the value of the company will increase.

H0: There is a positive or a negative relationship between Board Foreign Ownership and bank performance in the UK.

H3: There is no a positive or a negative relationship between Board Foreign Ownership and bank performance in the UK.

Ownership Structure and Banks Performance

Basuony Mohamed et al (2014) provided evidence that changes in performance are significantly associated with change in insider ownership. Moreover, he is also consistent with the view that insider ownership can be an effective tool in reducing agency cost. This factor measures as dummy variable that equals to zero if more than 50%of the bank is owned by individuals. One if more than 50% of the bank is owned by government agency.

H0: There is a positive or negative relationship between ownership concentration and banks performance.

H4: There is no a positive or negative relationship between ownership concentration and banks performance.

Audit Committee and Banks Performance

Lutzy, (2003) found that companies in the volatile industries experiencing instances of financial statement fraud had fewer audit committees, less independent audit committees, or fewer audit committee meetings. Its measure by the proportion of independent directors on the audit committee.

H0: There is a positive or a negative relationship between the independence of the audit committee members and banks performance.

H5: There is no a positive or a negative relationship between the independence of the audit committee members and banks performance.

Female Board Members and Banks Performance

Zelechowski and Bilimoria (2004) found that having a female CEO or female director on the board of directors will result in better financial performance.

H0: There is a positive or negative relationship between female board members and banks performance.

H6: There is no a positive or negative relationship between female board members and banks performance.

Financial Leverage and Banks Performance

H0: There is a positive or negative relationship between Financial Leverage and banks performance.

H7: There is no a positive or negative relationship between Financial Leverage and banks performance.

Bank Size and Bank Performance

H0: There is a positive or negative relationship between bank size and banks performance.

H9: There is no a positive or negative relationship between bank size and banks performance.

The Model Specification

the model is generally designed as follows:

Yit = αit + βkit Xkit + uit

Where the first subscript, i refers to the entity being observed, and the second subscript, t, refers to the date at which it is observed.

The Regression Models are Constructed

ROA = β0+ β1BOAS+β2PIND+β3FB+β4BOS+β5AC+ β6GNDER + β7LEVG+ β8BAKS+ u

ROE = β0+ β1BOAS+β2PIND+β3FB+β4BOS+β5AC+ β6GNDER + β7LEVG+ β8BAKS+ u

Tobin's q = β0+ β1BOAS+β2PIND+β3FB+β4BOS+β5AC+ β6GNDER + β7LEVG+ β8BAKS+ u

Data Collection

Since the main aim of this thesis is to conduct an investigation of the corporate governance practices of banks listed in London Stock Exchange (LSE) and their effect on banks performance used data from FTSE 100, and CG index companies in LSE. London Stock Exchange data are published daily. London Stock Exchange CG index contains aspects of corporate governance practices related to the board of directors, board compensation, the audit committee, shareholder rights, and disclosure and transparency. Moreover, secondary data of corporate governance of banks annual reports for accounting information, will be used for the analysis purpose period from 2010 to 2019.

Sample Selection

The Samples that we will use are biggest banks trading on the London Stock Exchange (UK) ranked by market capitalization as of December 31st. 2019.Sample used is an unbalanced panel dataset of commercial banks operating in the UK over the period 2010-2019. While financial data on banks is mainly obtained from the web page of the Banks chosen. Moreover, the information about board size and outside directors is hand-collected from the annual reports of individual banks.

CONCLUSION

The purpose of this study to examine the relationship between corporate governance mechanism and the UK banks performance, if LSE. The Samples that will use are biggest banks trading on the London Stock Exchange (UK) ranked by market capitalization as of December 31st. 2019, and their effect on banks performance we used data, of FTSE 100.The UK has one of mostly strong CG structure. In this research we will use ROA, ROE, Tobin Q as measure to the banks performance as many studies used them as mentioned early. Corporate governance will measure by use board size, board independent, ownership, foreign board, female board, audit committee, inflation, bank size, and leverage.

REFERENCES

Al-Amarneh, A. (2014). Corporate governance, ownership structure and bank performance in Jordan. International Journal of Economics and Finance, 6(6), 192-202.

Bhagat, S., & Jefferis, R. H. (2005). The econometrics of corporate governance studies. MIT Press.

Basuony, M., & Ehab, K. A. (2015). The effect of corporate governance on bank financial performance: evidence from the Arabian Peninsula.

Bathula, H. (2008). Board characteristics and firm performance: Evidence from New Zealand (Doctoral dissertation, Auckland University of Technology).

Bouheni, F. B., Ammi, C., & Levy, A. (2016). Banking Governance, Performance and Risk-taking. ISTE Ltd. London-UK.

Boussaada, R., & Karmani, M. (2015). Did board of directors have an impact on MENA bank performance? International Journal

of Economics and Finance, 7(4), 46-56

Choudhury, M. A., & Alam, M. N. (2013). Corporate governance in Islamic perspective. International journal of Islamic and Middle Eastern finance and management.

Financial Report Council. The Cadbury Report of corporate governance (1992). [Online]. Last accessd 4 April 2020: ashttp//: www.frc.org.uk.

Hoti, A., & Dermaku, A. (2018). Corporate Governance in the Banking Industry of Kosovo. International Journal of Finance & Banking Studies (2147-4486), 7(3), 20-34.

Kowalewski, O. (2016). Corporate governance and corporate performance: financial crisis (2008). Management Research Review.

Lutzy, J. M. (2003). Analysis of the proposed NYSE corporate governance and audit committee listing requirements. DePaul Bus. & Comm. LJ, 2, 99.

Makki, M., & Lodhi, S. A. (2013). Impact of corporate governance on financial performance. Pakistan Journal of Social Sciences, 33(2), 265-280.

Mehrotra, S. (2016). The Nature of Corporate Board Structure and Its Impact on the Performance of USA Listed Firms. IUP Journal of Corporate Governance, 15(1).

McIntyre, M. L., & Murphy, S. A. (2008). Board of director performance reporting. Corporate Governance: The international journal of business in society.

Mirchandani, A., & Gupta, N. (2018). Impact of ownership structure and corporate governance on the performance: A case of selected banks in UAE. International Journal of Economics and Financial Issues, 8(3), 197.

Muzhar Javed, R. S., Lodhi, R. N., & Malik, Q. U. Z. (2013). The effect of board size and structure on firm financial performance: A case of banking sector in Pakistan. Middle-East Journal of Scientific Research, 15(2), 243-251.

Mullineux, A. (2006). The corporate governance of banks. Journal of Financial Regulation and Compliance.

Naushad, M., & Malik, S. A. (2015). Corporate governance and bank performance: a study of selected banks in GCC region. Asian Social Science, 11(9), 226.

Isik, O. (2017). The dynamic association between CEO duality and bank performance: the moderating role of board size. Research Journal of Business and Management (RJBM), 4(4), 460-468.

Organisation for Economic Co-operation and Development (2001).). [Online]. Last access 4 April 2020: at:mhttp//:www.oecd.org.

Othman, R., Embi, R., Aris, N. A., Arif, S. M. M., Choo, H. C., & Ismail, N. (2016). Board Governance and Performance: An Exploratory Study of Malaysian Cooperative Organizations. Journal of Southeast Asian Research, 2016, 59-70.

Pande, S., & Ansari, V. A. (2014). A theoretical framework for corporate governance. Indian Journal of Corporate Governance, 7(1), 56-72.

Reddy, K., Locke, S., & Fauzi, F. (2013). Relevance of corporate governance practices in charitable organisations. International Journal of Managerial Finance.

Salim, R., Arjomandi, A., & Seufert, J. H. (2016). Does corporate governance affect Australian banks' performance? Journal of International Financial Markets, Institutions and Money, 43, 113-125.

Shahwan, T. M. (2015). The effects of corporate governance on financial performance and financial distress: evidence from Egypt. Corporate Governance.

Tricker, R. B., & Tricker, R. I. (2015). Corporate governance: Principles, policies, and practices. Oxford University Press, USA.

Zelechowski, D. D., & Bilimoria, D. (2004). Characteristics of women and men corporate inside directors in the US. Corporate governance: an international review, 12(3), 337-342.