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Role of Corporate Governance on Profitability of Non-Banking Financial Institutions in Bangladesh: A Study on Listed 'A Category' Firms

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Abstract

Corporate governance is a key component in this modern era for organizations' success since the concept requires firms to consider all the stakeholders' interests. For banking and non-banking financial institutions, adherence to good corporate governance might reduce irregularities and mismanagement increasing accountability, transparency, and profitability. This study is designed to determine the significance of the corporate governance factors of board size, board independence, board remuneration, executive remuneration, and shareholding concentration on the profitability (ROE and ROA) of the 'A Category' NBFIs in Bangladesh. The findings made through regression and correlation analysis, were inconclusive, having only board size and shareholding concentration being significant and decisive. The originality of the study lies in the duration (2015-2022) and having 'Shareholding Concentration' as an independent variable to correlate with profitability.

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1. Introduction

Corporate governance, in simple terms, is maximizing shareholders' wealth and ensuring a robust monitoring and control system (Afrin & Mohiuddin, 2017). In this modern era, a corporation is required to take into account the considerations of all the stakeholders, not only the shareholders to achieve the vision it has set. To safeguard the monitoring and the control system, the board of directors (BOD) has the lion's share of responsibilities. Thus, the attributes of the board play an immense role in the governance of an organization. But corporate governance has a certain scope of its function.

One of the pioneering and significant committees in corporate governance, the Cadbury Committee of 1992, set the scope of corporate governance. As per the chairman of the committee, Sir Adrian Cadbury, "Corporate governance is defined as holding the balance between economic and social goals, and also between individual and communal goals." (Fernando, Muraleedharan, & Satheesh, 2017). The report of the Cadbury Committee extended the scope further to the efficient utilization of resources discouraging fraud and mismanagement (Fernando, Muraleedharan, & Satheesh, 2017, p. 40).

Alike the Cadbury Committee definition, experts of the Organization for Economic Co-operation and Development (OECD) defined corporate governance as the directive measures and controls over an organization. In the exact words of the OECD, "Corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs." (Fernando, Muraleedharan, & Satheesh, 2017, p. 40). OECD emphasized on monitoring the performance of the organization by means of the distribution of roles and responsibilities between separate parties concerning the organization. A very practical definition is provided by Shleifer and Vishny which states, "Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." (Farinha, 2003, p. 4). In this definition, the author clearly pointed out the purpose of corporate governance, which is to maximize shareholders' wealth. As such, corporate governance aims at maximizing shareholders' wealth but also balances the interests of other stakeholders.

The depth of corporate governance in accordance with the above-mentioned definitions makes it essential for banking and non-banking financial institutions. Lack of corporate governance in financial institutions might lead to economic disaster as the banks act as the financial backbone of a country (Hopt, 2021). Afrin & Mohiuddin (2017) argued that several noncompliance with corporate governance mechanisms led to the global financial crisis in 2008. In a more direct sense, the infamous BASIC Bank scandal in Bangladesh during the period of 2009-2013, in which the bank misplaced BDT. 4,500 crores (Kamal & Begum, 2018). Allegedly, the BASIC Bank's then chairman issued the loans to his family or friends' owned businesses, from where the repayment was not made (Kamal & Begum, 2018). Such kind of credit risk increment results in an increase in non-performing loans which is as high as 9.36% in Bangladesh as of September 2022 (Uddin, 2022). As of November 2022, the non-performing loans for the state-owned banks in Bangladesh is 23.04% which is alarmingly high (TBS, 2022). The high amount of non-performing loans also accounts for less profitability for banks and non-banking financial institutions (Islam, 2021).

As such, the BOD, along with the chairman of the board is a deciding factor in the profitability of the organization. Consequently, it is important to inspect the profitability of banking and non-banking financial institutions with respect to the factors related to corporate governance. This study attempts to determine the role of corporate governance on the profitability of NBFIs in Bangladesh. The role includes mainly board attributes, along with shareholding concentration and compensation to the MD and CEO. In the Bangladesh context, several researchers have studied the impact of corporate governance on the banking industry's profitability such as Deb, Sarker, & Siddique (2017) and Rashid, Zobair, Chowdhury, & Islam (2020). There have been two notable studies to determine the role of corporate governance in Bangladesh NBFIs' financial performance. Mamun & Moniruzzaman (2014) observed the financial performance of NBFIs during the period of 2010-2011 in Bangladesh with the board attributes of board size, independent directors, board and CEO compensation, and ownership structure. Again, Sobhan (2021) studied the financial performance of NBFIs with respect to four variables namely, the board size, number of board meetings, board ownership structure, and directors' diversity during the timespan of 2012-2018. This study aims to contribute to the existing literature by regressing and correlating the financial performance of the NBFIs in Bangladesh for the duration of 2015-2022 having board size, board independence, directors' remuneration, executive remuneration, and ownership concentration as independent variables.

2. Literature Review

Board Size

Board size is defined as the total number of members elected by the shareholders of a particular firm in the Board of Directors (BOD). Due to a different points of view by numerous researchers, there is a debate over the optimal size of the board. While some studies opined that a larger board is beneficial for the shareholders, some studies found that a larger board is an obstacle when quick decisions are to be taken. Guest (2009) stated that a negative correlation exists between board size and form performance, meaning an increase in board size would decrease the firm's profitability. The findings from Guest (2009) are aligned with findings from Garg (2007) who recommended that a larger board might face difficulties to communicate, hence coordination would be hampered. However, it is also reported that increased board size has a positive relationship with firm performance (Kalsie & Shrivastav, 2016). Badu & Appiah (2017) agree with Kalsie & Shrivastav (2016).

Board Independence

Board independence is the ratio of independent board members to the total number of board members. An independent board member can represent the general shareholders, might bring an independent point of view. Only a few previous studies demonstrated a negative correlation between board independence and a firm's performance. Fuzi, Halim, & K. (2016) opined that independent directors have a positive impact on firm performance. In a rigorous assessment with more than 16,000 firm-year data, Liu, Miletkov, Wei, & Yang (2014) found a significant positive relationship between board independence and firm performance. They also noted that independent representation is utterly important in a weak investor protection environment to reduce agency cost (Liu, Miletkov, Wei, & Yang, 2014). Supporting the above-mentioned research works, Al-Matari, Mgammal, Alosaimi, Alruwaili, & Al-Bogami (2022) disclosed that firm performance is strongly subjected to independent representation in the board of directors. However, Wallison (2006) demonstrated that the function of independent directors is to ensure good governance in the firm, not to increase profitability.

Mamun & Moniruzzaman (2014) in their study of corporate governance factors' impacts on firm performance of Bangladeshi non-banking financial institutions (NBFI) found a significant positive relation between independent members ratio and firm performance. Additionally, the code of the Bangladesh Securities and Exchange Commission (BSEC) requires that there should be at least one-fifth of independent members in the board of directors. Also, the audit committee chairman should be an independent member (BSEC, 2018).

Board Remuneration

Almarayeh (2021) conducted a study ranging from 2009 to 2018 with 510 firm-year and concluded that board remuneration has a positive impact on a firm's performance. In their study of board supervision capability, Chiang & He (2010) mentioned that a higher remuneration package for the board might increase their motivation to supervise the management more effectively. Hence, an increase in the firm's performance is expected. From a Bangladeshi perspective, the NBFI's profitability with board remuneration has a positive correlation (Mamun & Moniruzzaman, 2014).

However, Brick, Palmon & Wald (2006) opined that over-compensated board members are detrimental to a firm's profitability. They supported their finding with the rationale that CEO's remuneration is directly related to board compensation. Thus, a high compensation package for both the shareholder and managerial parties leads to underperformance by the board (Brick, Palmon, & Wald, 2006).

Managing Director's Remuneration

According to Mamun & Moniruzzaman (2014), Bangladesh has a culture of having concentrated shareholding. Having more voting rights, a higher percentage of shareholders appoint a CEO who would perform according to their interests in return for a healthy remuneration package (Mamun & Moniruzzaman, 2014). In such a course of action, the profitability of the firm might deteriorate. In a similar study based in the UK, Ozkan (2011) found that concentrated ownership has a negative impact on CEO remuneration. Brick, Palmon, & Wald (2006) noted that CEO compensation is positively correlated to firm performance. They argued that the more experienced, expert, talented, and resourceful the CEO is, the higher the profitability. As such, the CEO should be compensated according to his capability (Brick, Palmon, & Wald, 2006). Harun & Hamid (2016) opined that a quality CEO will lead to the success of the organization like Paul Steven Jobs with Apple, or might dismantle the company like Lehman Brothers' CEO did. Hence, a good CEO should be compensated enough to motivate him/her to maintain a certain dedication toward the organization (Harun & Hamid, 2016).

Shareholding Concentration

Current literature mostly supports the fact that ownership concentration is inversely related to a firm's financial performance. Wang & Shailer (2015) expressed through analysis that the countries with high and medium shareholding concentration are lagging behind low shareholding concentrated countries in terms of financial performance. Mamun & Moniruzzaman (2014) raised the issue of inferior CEO performance due to shareholding concentration which ultimately leads to reduced profitability. However, Alimehmeti & Paletta (2012) stated that higher ownership concentration results in higher control over management. Hence, the profitability increases (Alimehmeti & Paletta, 2012). Nashier & Gupta (2020) agrees with Alimehmeti & Paletta (2012).

3. Methodology

Data Collection

To conduct the study, 11 listed non-banking financial institutions (NBFI) of the Dhaka Stock Exchange (DSE) have been selected. The data ranges from the period of 2015 - 2021 (7 years). With 11 NBFIs and 7 years of data, 77 firm-year is the size of the sample data. It has to be noted that the 11 firms are among the 13 firms of 'A Category' NBFIs under DSE. 'A Category' firms have been chosen due to the availability of the annual reports. The author has ignored the consolidated financial statements as they include the subsidiaries' data as well. Hence, the data are solely focused on the NBFI's performance and corporate governance factors.

Variable Definition

Dependent Variables

In order to determine profitability, the ratios of Return on Equity (ROE) and Return on Assets (ROA) have been chosen. For NBFIs, ROE and ROA are good determinants of a firm's performance (Imtiaz, Mahmud, & Faisal, 2019). In addition, Bangladesh Bank, to supervise the profitability of NBFIs in Bangladesh, uses the measures of ROE and ROA (BB, 2022). ROE has been determined by the division of net profit by total shareholders' equities, while ROA has been determined by the division of net profit by total assets.

$$\text{ROE} = \frac{\text{Net Profit After Tax}}{\text{Total Shareholders' Equities}}$$

$$\text{ROA} = \frac{\text{Net Profit After Tax}}{\text{Total Assets}}$$

Independent Variables

From the hypotheses, the corporate governance factors for the study are board size, board independence, board remuneration, managing director's remuneration, and ownership concentration.

Table 1: Independent Variables' Definition

Abbreviation	Variable Name	Definition
Brd_Size	Board Size	The total number of executive and non-executive directors in the board of directors
Ind	Board Independence	The ratio of independent directors to the total number of directors in the board
Brd_Rem	Board Remuneration	The ratio of the fees paid to the directors to net income. Directors' remuneration is mainly paid for attendance in the board meetings and various committee meetings
Exc_Rem	Executive Remuneration	The ratio of Salary and benefits paid to the managing director and CEO of the firm to the net income
Share_Conc	Shareholding Concentration	The highest percentage of shares held by a shareholder, either individual or institutional.

All the independent variables were either calculated or retrieved from the annual reports of the individual firms.

The working model

The role of corporate governance factors on the profitability of the NBFIs of Bangladesh would be determined through the above-mentioned five dependent variables. Two multiple linear regression models would be utilized, one with ROE as the dependent variable and the other with ROA as the dependent variable. The equation for the regression models is as followed:

$$\mathbf{ROE = \alpha_1 + \beta_1 Brd\_Size + \beta_2 Ind + \beta_3 Brd\_Rem + \beta_4 Exc\_Rem + \beta_5 Share\_Conc + \varepsilon_1}$$

$$\mathbf{ROA = \alpha_2 + \beta_1 Brd\_Size + \beta_2 Ind + \beta_3 Brd\_Rem + \beta_4 Exc\_Rem + \beta_5 Share\_Conc + \varepsilon_2}$$

In the models, α_1 and α_2 denote the y-intercepts of the ROE and ROA models respectively. The y-intercept is interpreted as the ROE and ROA of the firms when there is no increase in the other five independent variables. Furthermore, ε_1 and ε_2 are the standard errors for the models of ROE and ROA respectively.

4. Descriptive Analysis

The descriptive statistics from Table 2 draw a comprehensive picture of corporate governance standards followed by Bangladesh's NBFIs and their profitability.

Table 2: Descriptive Statistics

Variables	Minimum	Maximum	Mean	Std. Deviation
ROE	**-0.1205**	**0.2178**	**0.1000**	**0.0579**
ROA	**-0.0119**	**0.0401**	**0.0143**	**0.0082**
Brd_Size	**7.00**	**14.00**	**10.3377**	**1.2938**
Ind	**0.1111**	**0.9000**	**0.2790**	**0.2058**
Brd_Rem	**-.0042**	**.0375**	**0.0034**	**0.0054**
Exc_Rem	**-.0406**	**.1076**	**0.0232**	**0.0211**
Share_Conc	**0.0480**	**0.2700**	**0.1451**	**0.0737**

The mean ROE is 10%, which indicates a satisfactory return on equities. But the standard deviation is drawn as 5.79%, which indicates that the ROE among the firms is very fluctuating. The minimum ROE being negative supports the comparatively high standard deviation. The minimum ROE and ROA are negative, which means that the net profit for some firms in certain years has been negative. The ROA shows a moderate performance by the NBFIs of Bangladesh as the mean is 1.43% with a standard deviation of 0.82%.

The average board size contains 10-11 board members, with a standard deviation of 1.29. The statistic is satisfactory. The board independence ratio has a mean of 27.90%, but the high ratio is due to the independent members present in the Investment Corporation of Bangladesh. The board members are elected by the government of Bangladesh, the Bangladesh Bank, and the Bangladesh Securities and Exchange Commission (BSEC). In the Investment Corporation of Bangladesh, other than the managing director, all other board members are independent. As such, the independence means is high. But the standard deviation is also high at 20.58%, which reveals that at some firms the independent directors are of low numbered. The minimum independent director ratio is only 11.11%, whereas it should have been at least 20% in accordance with the Bangladesh Securities and Exchange Commission's (BSEC) guideline of having at least one-fifth of total board members as independent directors. Evidently, an irregularity is observed in compliance with board independence.

Board remuneration and executives' remuneration ratios against net profit are also satisfactory. Hence, it can be drawn that the board and the managing directors are compensated quite well for their expertise. However, the standard deviation compared to the mean is again high, especially for executive remuneration. As such, it can be concluded that the package for executive remuneration is varying highly from firm to firm. Furthermore, the variance reflects the fact that some firms incurred losses at different years. The losses made affect the ratios of remunerations to net profit as well. The statistic of shareholding concentration reveals that on average 14.51% of shares are owned by a single owner, institutional or induvial. The standard deviation of just over 7% affirms that at some firms, the shareholding is moderately concentrated.

Regression Analysis

Test of fit

The R-Squares of both models (Table 3) are quite satisfactory. While the ROE model explains 56.00% of the variance in all five of the independent variables altogether, the ROA model explains 59.70% of the variance in the independent variables.

Table 3: R Square Analysis

Model	**R**	**R-Square**	**Adjusted R-Square**
ROE	**0.748**	**0.560**	**0.442**
ROA	**0.773**	**0.597**	**0.489**

Table 4: ANOVA Table Analysis (ROE)

Model		Sum of Squares	df	Mean Square	F	Sig.
ROE	Regression	0.137	15	0.009	4.754	0.000
	Residual	0.107	56	0.002		
	Total	0.244	71			

Table 5: ANOVA Table Analysis (ROA)

Model		Sum of Squares	df	Mean Square	F	Sig.
ROA	Regression	0.003	15	.000	5.534	0.000
	Residual	0.002	56	.000		
	Total	0.005	71			

The ANOVA tables' of ROE and ROA from Table 4 and Table 5 respectively have p-values lower than the level of confidence (5%). As such, both models fit quite well. The interpretation can also be made as at least one of the five independent variables is significant to the model.

Table 6: Multicollinearity Statistics

Independent Variable	Tolerance	VIF
Brd_Size	0.921	1.086
Ind	0.591	1.692
Brd_Rem	0.447	2.239
Exc_Rem	0.407	2.459
Share_Conc	0.699	1.431

Table 6 decrypts the multicollinearity analysis among the independent variables. The multicollinearity analysis is conducted to detect any kind of correlation among the independent variables. If the VIF value is less than 5, the multicollinearity is not of any issue in the models. Since the VIF value for all the independent variables is less than 5, the model does not contain any significant multicollinearity.

Hence, in accordance with the R-Square analysis, ANOVA table analysis, and VIF analysis the models are well-fitted and are significant.

Regression and Correlation Analysis

To find out the significance of each independent variables on ROE and ROA, regression analysis utilizing p-value has been conducted.

Table 7: Regression Analysis (ROE)

Model		Standardized Coefficients	Sig.	Test
		Beta (β)		
ROE	(Constant)		.004	N/A
	Brd_Size	0.381	.007	Significant
	Ind	0.936	.156	Insignificant
	Brd_Rem	- 0.400	.021	Significant
	Exc_Rem	0.496	.005	Significant
	Share_Conc	0.341	.417	Insignificant

Table 7 represents the regression analysis for the ROE model. It is evident that with a p-value of less than 0.05 board size, board remuneration and executive remuneration are significant to ROE, the other two variables being insignificant. The correlation derived from Table 8 indicates a moderately strong positive correlation. Board remuneration and executive remuneration are significant to ROE. But while board remuneration has a moderately weak negative correlation, executive remuneration has a moderately weak positive correlation. Board independence contains a weak negative correlation with ROE. But independence becomes insignificant with a p-value of more than 0.05. The finding is different from the previous literature available. The reason for the independent director's insignificance might be the high concentration of independent directors in the Investment Corporation of Bangladesh and the negative ROE in some of the firms. Finally, the shareholding concentration is also insignificant to ROE, hence the weak negative correlation becomes insignificant as well.

Table 8: Regression Analysis (ROA)

Model		Standardized Coefficients	Sig.	Test
		Beta (β)		
ROA	(Constant)		.004	N/A
	Brd_Size	0.364	.007	Significant
	Ind	1.131	.075	Significant
	Brd_Rem	- 0.268	.102	Insignificant
	Exc_Rem	0.374	.027	Significant
	Share_Conc	0.291	.469	Insignificant

Table 9: Correlation Analysis

	ROE	ROA	Brd_Size	Ind	Brd_Rem	Exc_Rem	Share_Conc
ROE	**1**	**.557**	**.602**	**-.218**	**-.028**	**.028**	**-.136**
ROA		**1**	**.328**	**.124**	**-.030**	**-.019**	**-.063**

Like the ROE model, the ROA model's three independent variables have proved to be significant, namely board size, board independence, and executive remuneration. The board size with a 0.328 correlation, has a moderately weak positive correlation with ROA. Unlike the ROE model, board independence is significant to the ROA model. Also, the correlation is found to be a very weak positive one. Alike board independence, executive remuneration also has a very weak positive correlation with the ROA. However, board remuneration and shareholding concentration are both insignificant to ROA. Also, board remuneration and shareholding concentration both have a very weak negative correlation.

5. Findings

The board size has a positive significance in both the ROE and ROA models. The positive significance is interpreted as an increase in board size would increase the profitability of the 'A Category' NBFIs. The finding complies with Kalsie & Shrivastav's (2016) and Badu & Appiah's (2017) recommendations. The independence of the board has significance in the ROA model but is insignificant in the ROE model. As a result, enough evidence of board independence could not be found to draw a conclusion on the impact of the variable on the financial performance of NBFIs. Like board independence, board remuneration could not be concluded either due to having significance with the ROE model, but not with the ROA model. For being significant on both ROA and ROE, it might be established that executive remuneration is significant to an NBFI's profitability. But the correlation has both positive and negative signs with ROA and ROE respectively. Finally, shareholding concentration has proved to be insignificant to the profitability of the 'A Category' NBFIs, but with a negative correlation. As such, an increase in shareholding concentration would decrease the profitability of a firm.

6. Recommendations

Among the five independent variables, two were able to draw conclusive evidence (board size and shareholding concentration). According to the findings of this study, an increased number of board members would also increase the profitability of an 'A Category' NBFI in Bangladesh. However, as the literature suggests, the board size should not be too large. Again, the board size should be subject to the firm size. But it is observed from the annual reports of the studied NBFIs that, the institutional shareholders elect board members. The firm which has more institutional shareholders automatically has a larger board size despite the size of the board.

Shareholding concentration having a clear negative correlation might cause detriments to the profitability of the 'A Category' NBFIs. This finding is aligned with the previous finding of Mamun & Moniruzzaman (2014) who stated that concentrated shareholding results in appointing a CEO loyal to the concentrated owners. As such, the management body and the BOD are not truly separate in such a setting. The decisions taken might be questionable and not fruitful for the firm, decreasing profitability. Consequently, it is recommended that concentrated ownership does not overpower the BOD.

Since the other three variables (board independence, board remuneration, and executive remuneration) are not conclusive enough, this study is unable to make comprehensive recommendations based on them.

7. Conclusion

Though the study is inconclusive to make decisions, the findings from board size and ownership concentration are aligned with the previous findings of various research. The models of ROE and ROA fitted well, but there might be an issue with selecting 'A Category' firms only which might have led to three variables not being conclusive. Hence the limitation of the study is the selection of the sample. Another limitation has been the unavailability of the information required which led to five missing data in the variable 'Shareholding Concentration' and one missing data in the variable 'Board Independence', which might have caused a manipulated finding.

This study focused on only 'A Category' NBFIs. Further research could focus on all the firms in NBFI in Bangladesh. Also, a comparative study of the profitability among the 3 different categories might be an influential tool to contribute to the current literature.

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