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   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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THE EFFECT OF BOARD STRUCTURE ON FINANCIAL PERFORMANCE OF SRI LANKAN LISTED BANKS

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ABSTRACT

The purposes of this study were to determine the impact of board characteristics as corporate governance components (Board size, Non Executive Director Proportion, Independent Director Proportion and Female Director Proportion) on the financial performance of a sample of ten Sri Lankan banks listed on Colombo stock exchange. Data were collected from secondary data of listed banks for the period of 2008 to 2012.because it is suggested by Securities and Exchange Commission of Sri Lanka and CSE to adopt the compliance of rules of corporate governance mandatory among the listed companies with effect from April 2008.the data collected were analyzed by SPSS using correlation and regression analysis. The findings reveal that, there is no significant relationship between board structure and financial performance. These results are consistent with prior empirical studies. This may be due to the fact that in Sri Lanka, banks are still not adequately practiced corporate governance guidelines or there may be number of other factors which can have an impact on bank performance that need to be studied. Hence further research is significantly recommended.

KEYWORDS
Corporate Governance, board structure, bank performance, Sri Lanka.

1. THEORETICAL BACKGROUND

Good corporate governance is globally accepted as being fundamental to an organization's competitiveness, growth and sustainability. There is great attention on Boards of Directors to discharge their duties with high ethical values and accountability in their commitment to good governance practices. Strong business ethics, sound policies and procedures, effective and efficient monitoring systems are considered as ingredients of good corporate governance system.

Corporate governance is a crucial issue for the management of banks. Corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management. It is not a disputed fact that banks are crucial element to any economy; this therefore demands that they have strong and good corporate governance if their positive effects were to be achieved (Basel Committee on Banking Supervision, 2003). Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision-making.

Effective corporate governance mobilizes the capital annexed with the promotion of efficient use of resources both within the company and the larger economy. It also assists in attracting lower cost investment capital by improving domestic as well as international investor's confidence. Good corporate governance ensures the accountability of the management and the Board. The Board of directors will also ensure legal compliance and take impartial decisions for the betterment of the business.

Good corporate governance can add value to developing sound corporate management and enriching the results of corporate entities for society in general and shareholders in particular to be the beneficiaries. To investigate the reasons for the effectiveness of corporate governance in the context of Sri Lanka, this study will examine literature on the relationship between board structure, corporate reporting and firm performance.

The banking institution occupies a vital position in the stability of the nation's economy. It plays essential roles on fund mobilization, credit allocation, payment and settlement system as well as monetary policy implementation. Management is expected to exhibit good governance practices to ensure achievement of it objectives and avoid the consequences of failure leading to loss of confidence.

From a banking industry perspective, corporate governance involves the manner in which their boards of directors and senior management govern the business and affairs of individual banks, affecting how banks set their corporate objectives, run day-to-day operations, consider the interests of various stakeholders, align corporate activities with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations and protect the interests of depositors

Banks are "special" as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation.

The role of banks is integral to any economy. They provide financing for commercial enterprises access to payment systems and a variety of retail financial services for the economy at large. The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing in many cases a government safety net to compensate depositors when banks fail.

Securities and Exchange Commission of Sri Lanka as the apex regulator of the Sri Lankan Capital Market is committed to maintain a higher standard of Corporate Governance in order to maintain the market integrity. In view of this broader objective, the Securities and Exchange Commission of Sri Lanka together with the Institute of Chartered Accountants of Sri Lanka published the "Code of Best Practices on Corporate Governance" in the year 2008 in order to establish good corporate governance practices in Sri Lankan Capital Market.

2. OBJECTIVE OF THE STUDY

The main objective of this study is to find out Does the corporate governance practices affect on firm performance of selected banks? In particular the study sought to:

- Examine the development of corporate governance practices in the context of the Sri Lankan business environment.
- Determine the relationships between corporate governance practices (such Board size, Non Executive Director Proportion, Independent Director Proportion and Female Director Proportion) on bank performance

3. LITERATURE REVIEW

Several studies have been conducted so far and still going on to examine the relationship between firm performance and corporate governance mechanisms, but the results are mixed.

Using data from Jordanian banks, Mousa F. Al Manaseer, Riyad Mohamad Al-Hindawi, Mohamad Abdulrahim Al-Dahiyat and Iaad Issa Sartawi (2012) found a positive relationship between corporate governance dimensions: the number of outside board members and foreign ownership and Jordanian banks' performance. Whereas, board size and the separation of the role of CEO and chairman have a negative relationship with performance.

Giulia Romano, Paola Ferretti and Alessandra Rigolini (2011) find that board size does not affect Italian bank holding companies' performance and that smaller audit committees charged with internal control activities perform better, increasing vigilance over board decisions and activities and, thus, concurring to enhance banks' profitability. They also find a significant negative relationship between the percentage of independent directors in the audit committee and banks' performance in terms of both ROE and ROA. Their study shows also a significant positive relationship between the presence of women on the board of directors and both ROE and ROA, even if the representation of women in Italian bank holding companies' boards is still scarce.

Empirical studies on the effect of board membership and structure on performance generally show results either mixed or opposite to what would be expected from the agency cost argument. While some studies find better performance for firms with boards of directors dominated by outsiders (Pearce and Zahra 1992; Vafeas, 1999), others find no such relationship in terms of accounting profits or firm‟s value (**Daily and Dalton, 1992**; Mehran 1995; Rosenstein and Wyatt 1997; Klein 1998 and Bhagat and Bolton 2005). Brickley, Coles and Terry (1994) find a positive relationship between the proportion of outside directors and the stock market reaction to poison pill adoptions.

With specific reference to bank industry, some empirical researches regarding different countries find no significant relationship between performance measures and board size (Love and Rachinsky, 2007; Shelash Al-Hawary, 2011; Bino and Tomar, 2007; Busta, 2007; Mayur and Saravanan, 2006; Simpson and Gleason, 1999). However, in banking researches, the results regarding the effectiveness of outside directors are mixed. Some empirical researches in the last decades show no significant relationship between board composition, considered as the proportion of outsiders or of independent board members on the board, and banks performance (Simpson and Gleason, 1999; Adams and Mehran, 2008; Love and Rachinsky, 2007; Adams and Mehran, 2005; Pi and Timme, 1993). Although the size of audit committee is influenced mainly by the size of the company and of its board of directors, a larger audit committee may not necessary cause in more effective functioning, as a larger committee may lead to unnecessary debates and delay the decisions (Lin et al., 2008).

With reference to the relationship between gender diversity and firm performance, the few existing empirical studies show contrasting results. Considering the US context, Zahra and Stanton (1988) find no statistically significant relationship between gender diversity and firm performance. Carter et al. (2003) report statistically significant positive relationships between both the presence and the percentage of women on the board of directors and firm value. Also Heinfeldt (2005) finds a positive relationship between the percentage of female board members and the market value added (MVA). Conversely, Shrader et al. (1997) show a negative relationship between the percentage of female board members and firm performance.

Beiner, Drobetz, Schmid and Zimmermann (2003) conducted a study over companies listed on the Swiss Stock Exchange (SWX). Study did not find a significant relationship between board size and firm valuation, as measured by Tobin‟s Q.

The role of auditor is important in implementing corporate governance principles and improving the value of a firm. The principles of corporate governance suggest that auditors should work independently and perform their duties with professional care. In case of any financial manipulation, the auditors are held accountable for their actions as the availability of transparent financial information reduces the information asymmetry and improves the value of a firm (Bhagat and Jefferis, 2002).

Bennedsen, Kongsted and Nielsen (2006) studied the relationship between board size and performance of 500 Danish firms. Their study also supported a negative relation between the two variables. Adams and Mehran (2002) accessed the relationship between banking firms‟ performance (represented by Tobin‟s Q) and board size and found a non-negative relationship between board size and Tobin‟s Q.

4. METHODOLOGY OF THE STUDY

There were 15 banks listed in the CSE in 2008. As per the scope of the study researcher has selected these organizations listed in the CSE as the population. Ten of these organizations have been selected randomly as the sample of the study.

The study examined the data for the years 2008, 2009, 2010, 2011 and 2012. The reason for selection of the years was that the corporate governance guidelines were introduced in 2003. Reporting of corporate governance practices was voluntary during this period. The code of corporate governance was mandated in 2007 to be effective for companies reporting on or after the 1st April 2008. Therefore, the year 2008 was an important year to examine the effectiveness of the voluntary code on performance.

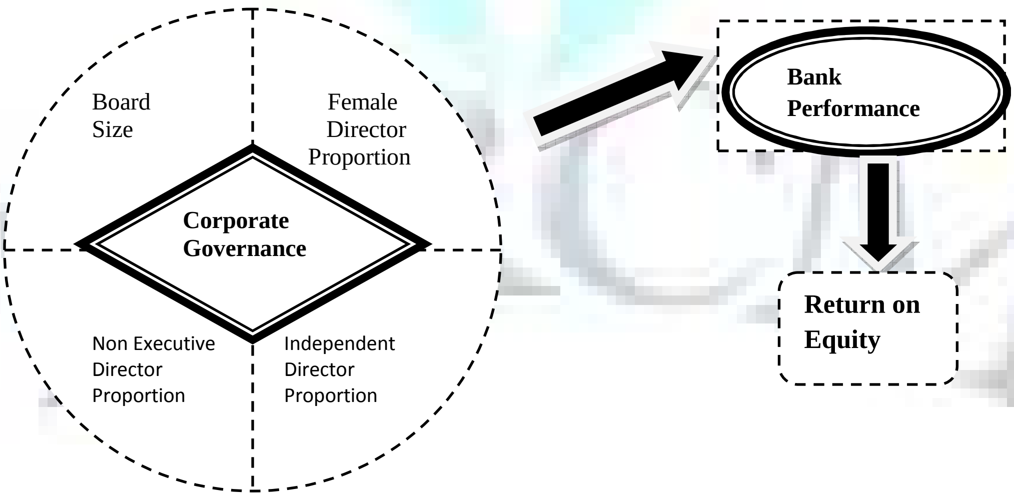
The data of the study is composed of two kinds of data. They are banks' financial information and the banks' corporate governance information over the period 2008-2012. The sources of these data are the financial data and the banks' corporate governance available on Colombo Stock Exchange (CSE) websites, annual reports, and the Colombo Stock Exchange publication "The Hand book of listed companies".

The data required for the study included board size, composition of the board (number of non-executive directors) and audit committee (details of the audit committees). Performance data used in the study were return on investment (ROE). SPSS (Statistical Package for Social Science) was used to analysis the data to test the hypothesis. Correlation and Regression were used to test the hypothesis.

4.1 CONCEPTUAL FRAMEWORK

The model used to conceptualize the dependent and independent variables was based on many other models used by different researchers over the years.

FIGURE: CONCEPTUALIZATION MODEL



1.2 VARIABLES DESCRIPTION

Tables 1a and 1b below show the variables used to operationalise the constructs and their measurement.

TABLE 1a: DEPENDENT VARIABLE DESCRIPTION

Concept	variable	Measurement
Bank Performance	Return on Equity[ROE]	$\frac{\text{Earnings before interest and tax}}{\text{shareholders' funds}}$

TABLE 1b: INDEPENDENT VARIABLE DESCRIPTION

Concept	variable	Measurement
Board Characteristics	Board size	Number of directors on the board.
	Non Executive Director Proportion	Proportion of outside directors sitting on the board.
	Independent Director Proportion	number of Independent directors on the board
	Female Director Proportion	Presence of female members on the board of directors

4.3 HYPOTHESES

The hypothesis presented in this study will be tested to investigate the effect of corporate governance practices on bank performance in Sri Lanka.

H1: There is a positive significant relationship between board size and bank performance.

H2: The relationship between the proportion of non executive directors and the bank performance is positively statistically significant.

H3: The bank performance is positively related to the proportion of independent directors on the board of directors.

H4: The proportion of female directors is positively associated with bank performance.

4.4 MODEL SPECIFICATION

The linear model used in this study is as follows:

$ROE=\alpha+\beta 1BSISE+\beta 2NEXD+\beta 3IND+\beta 4WO+\varepsilon$

Whereas:

β=Intercept

ROE= Return on Equity

BSIZE= Board size

NEXD= Non Executive Director Proportion

IND= Independent Director Proportion

WO= Female Director Proportion

ϵ = Standard error of the sample

5. RESULTS OF ANALYSIS

5.1 DESCRIPTIVE STATISTICS

TABLE 2: BELOW SUMMARIZES THE DESCRIPTIVE STATISTICS OF ALL THE VARIABLES USED IN THIS STUDY

	Minimum	Maximum	Mean	Std. Deviation
Board size	7	13	9.98	1.597
Non-executive Director Proportion	5	10	8.16	1.376
Independent Director Proportion	1	8	4.34	1.636
Female Director proportion	0	3	0.94	0.935
Return on Equity	0.221	0.3360	0.2082	0.08932

According to the table 2, it shows that the board of director consists of around ten directors and it has wide range from 7 to 13 with a variation of around two within the banks in Sri Lanka. The Cadbury committee report (1992) also recommends the size of the board to be between 8 and 10. Non-executive director proportion is about nine out of the total board members. The table shows a mean of 8.16 with a standard deviation of 1.376 and it ranges between five to ten non executive members. The number of independent director sitting in the boards of directors floats from one to 8, with a mean of 4.34, while, the presence of women on Sri Lankan bank' board floats from 0 to 3 with a mean of only 0.94, implying that there are boards without any female representation.

5.2 CORRELATIONS

In order to test the hypotheses, the researcher has obtained correlations output through SPSS statistical packages. The following figure shows the results of correlations analysis.

TABLE 3: CORRELATIONS BETWEEN BOARD CHARACTERISTICS AND BANK PERFORMANCE

Board Characteristics	**Return on Equity**
Board size	
Correlation Coefficient	.106
Sig. (2-tailed)	.464
Non-executive Director Proportion	
Correlation Coefficient	.157
Sig. (2-tailed)	.276
Independent Director Proportion	
Correlation Coefficient	.048
Sig. (2-tailed)	.742
Female Director proportion	
Correlation Coefficient	.131
Sig. (2-tailed)	.364

Table 3 shows the relationship between the board Characteristics and bank performance (ROE as the measures of firm performance). It is noted that none of the relationships are statistically significant which is in line with many of the previous studies. This result is supported by empirical evidence carried out by D.N.Ranasinghe (2010), Velnampy (2013).

5.3 REGRESSION ANALYSIS

A simple linear regression was carried out to recognize the impact of board characteristics on bank performance. Table 3 shows the results of the analysis.

TABLE 4: MODEL SUMMARY

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.199[a]	.040	-.046	.0913352

a. Predictors: (Constant), FED, BSIZE, IND, NED

According to this table R2 values of 0.040 indicate that the board characteristics of the listed banks is contributing to the ROE by 4% and the remaining 96% can be attributed by other factors which are not studied, because they are outside the scope of the study. R2 values indicate that there may be number of variables which can have an impact on performance that need to be studied.

TABLE 5: ANOVA- ROE AS A DEPENDENT VARIABLE

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.015	4	.004	.464	.762[a]
	Residual	.375	45	.008		
	Total	.391	49			

a. Predictors: (Constant), FED, BSIZE, IND, NED

b. Dependent Variable: ROE

Table 5 shows the analysis of variance (ANOVA) of the variable. With F- values of 0.464 (sig 0.762) for ROE as performance proxies, it clearly shows that there is no significant relationship between the dependent variables(ROE) and the independent variables(the board characteristics) at 1%, 5% and 10% levels.

TABLE 6: COEFFICIENTS FOR PREDICTORS OF PERFORMANCE

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.124	.091		1.361	.180
	BSIZE	.000	.013	-.008	-.033	.974
	NED	.011	.017	.167	.646	.521
	IND	-.003	.010	-.047	-.262	.795
	FED	.012	.015	.125	.823	.415

a. Dependent Variable: ROE

The relationship between board characteristics and the performance measure (ROE) is not statistically significant. The implication of this is that for the sampled firms, there is no relationship between the banks' financial performances and corporate governance. Further t values for all four variables of corporate governance are insignificant even at 5% level. It means that these variables are not contributing to the performance measures of ROE. This outcome also has the support of D.N.Ranasinghe (2010) Weisbach (1991), Bhagat and Black (2002) and Velnampy (2013).

6. CONCLUSION AND RECOMMENDATION

Several studies have been conducted on the examination of the impact of corporate governance on bank performance, but there are mixed outputs in different contextual frame work. This study has focused on analyzing the relationship that exists between bank performance using ROE and four board characteristics as a corporate governance mechanism.

A sample of ten listed banks from the financial year 2008 to 2012 is used. Board size, Non Executive Director Proportion, Independent Director Proportion and Female Director Proportion were taken as the corporate governance variable where as ROE were taken as the measures of bank financial performance.

The study reveals that determination of corporate governance is no statistically significant to the performance measures of the bank. Therefore, it can be concluded that financial performance of the bank is independent of the corporate governance mechanism. This result is consistent with prior empirical studies.

As with any corporate governance, study has some limitations. This is only focused of financial accounting measures of performance. It is hereby suggested that attention should be put in the inclusion of non financial performance aspects. The sample used in this study consisted only ten banks which indicate the sample is relatively small. More sample size may have revealed the hypotheses to be significant. Hence further research is significantly recommended.

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