



Board Independence, Risk Management, and Financial Performance: The Post COVID Bangladesh Banking Sector Evidence

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ABSTRACT

The function of non-executive, independent directors in determining the performance of the firm has been a debatable topic in the existing literature on emerging markets. In the current study, we examine the interrelation between board independence, risk-management practices and financial performance of a sample population of 36 banks listed publicly in the Dhaka Stock Exchange (DSE) in a Post COVID era. Despite the expectations of the agency theory, according to which the independent oversight of firms should improve the value of the firm, however, our results show that the degree of board independence is statistically non-significantly correlated with the risk-management indicators, as well as the financial performance measures. These results suggest that in the Bangladeshi environment, non-executive directors are often simply a paper tiger, meeting regulatory formalities, but with no ability to perform any substantive oversight. The findings of our study show the importance of structural changes in the selection of directors in order to address the impact of undiluted ownership and political power.

Keywords: Banks, Board Independence, Corporate Governance, Risk Management, Financial Performance, Post COVID.

INTRODUCTION

The banking sector stability is an ingredient of sustainable economic growth, particularly in the developing economies similar to Bangladesh. This has been the subject of intense examination in recent years after a succession of high-profile financial scandals such as the Basic Bank and the Hallmark- Sonali Bank scandals highlighted significant systemic cracks in the in-house control and risk management (Islam et al., 2021). The above failures have diverted the attention to the corporate governance arrangements, especially the ability of the Board of Directors in checking the management and ensuring the interests of the stakeholders (Rashid, 2018). This research paper looks at the extent to which the independence of the board of directors of financial institutions in Bangladesh is linked to quantifiable improvements in risk management practices and performance.

The correlation between the firm performance and board independence has been studied in multiple studies done previously (Orazalin et al., 2016; Abdullah, 2016; Bhatt and Bhattacharya, 2015; Chen et al., 2015; Knyazeva et al., 2013; Mashayeki and Bazaz, 2008; Bhagat and Bolton, 2008; Krivogorsky, 2006; Blue Ribbon Committee, 1999, Klein 1998, Ermack 1996, Hermalin and Weisbach 1991, Treadway Commission, 1987; Fama and Jensen, 1983) However, the results of such studies are inconclusive about the impact of independent directors in improving the performance of a company. As an example, Knyazeva et al. (2013) claims positive and significant effect of board independence on company performance was detected, whereas Abdullah (2016) failed to find any evidence of a positive relationship between the percentage of independent directors and company performance in Malaysian public companies. These opposing findings justify the need to conduct more research on the connection that exists between board independence and company performance thus enhancing the comprehension of how independent directors can diminish agency conflicts between the management and investors to enhance company performance. Furthermore, the present study is unique to the previous research in four aspects. First, despite the fact that most of the past studies (Bhatt and Bhattacharya, 2015; Mashayekhi and Bazaz, 2008) do not include banks due to their unique organizational structure and

business model, financial institutions like banks are crucial in capital creation among business organizations in emerging markets like Bangladesh. As a result, this study's findings can be used in understanding corporate governance effectiveness in banks that are central to the financial market of such economies. Second, although the agency problem between the investors and the managers have been extensively discussed in the corporate governance works to investigate the correlation between the corporate governance mechanisms and the company performance, banks largely experience conflicts of interest among the management and the depositors. This agency problem is rarely considered by previous researchers to evaluate the effectiveness of independent directors to reduce such conflicts and enhance the performance of a company. The current research will thus focus on banks only in a bid to give empirical data on the impact of independent directors in mitigating the special forms of conflicts that characterize the profitability of banks. Third, the current corporate governance studies in the framework of financial companies (Lee et al., 2016; Kallamu and Saat, 2015) rarely searched the correlation between board independence and risk management. Since it is a major performance indicator of banks, this research on the association between board independence and risk-management performance has added to the corporate governance research by providing unique proof on how board independence contributes towards the risk-management performance of banks. Lastly, latest studies on the association between board independence and risk-management performance for the overall Bangladesh financial sector were done in a Pre COVID era. However, Bangladesh's banking sector is not invulnerable to negative effects post-COVID-19. A research using the Bangladesh framing is relevant for this study, as it provides a possibility for the development of currently effective strategies for enhancing the risk-management performance abilities in Bangladesh and other developing countries (Kien & That, 2022).

In a nutshell, the research study will be of value to corporate governance study as it offers some of the rare empirical proof on the link between board independence and risk-management and financial performance at banks in Bangladesh.

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Agency Theory Verses Institutional Reality

The agency theory states that conflicts of interests for shareholders are reduced when independent directors are present (Fama & Jensen, 1983). In the developed market settings, the existence of autonomous corporate boards is often associated with an increment in the company value and a corresponding reduction in risk-taking actions.

However, this relation is usually distorted in the emerging economies. Researchers have argued that in places like Bangladesh independent directors are often selected due to personal or political affiliation as opposed to being selected due to competence and therefore make ineffective monitors (Mamun, 2020; Rashid, 2018) This is what is explained as the illusion of independence where the management meet the statutory requirements but are deprived of the agency to challenge the controlling shareholders (Rashid et al., 2018).

Board Autonomy and Firm Performance

Any empirical studies of board independence in the context of Bangladesh always provide inconsistent results. The available evidence in select studies, especially the ones carried out by Rahman and Islam, does not lead to one conclusion about the correlation of board independence versus the performance of companies (Abdullah et al., 2016). However, the agency theory (Jensen and Meckling, 1976) assumes that board independence is necessary to check managerial opportunism and protect the interests of the investors. The Code of Corporate Governance 2012 of Bangladesh Securities and Exchange Commission (BSEC) requires listed companies in Bangladesh to have at least 20% independent directors, which emphasizes the importance of independence in reducing agency conflict and raising the performance of companies. Additionally, the independent directors in banks are capable of objectively supervise the risk-management procedures, which is crucial in securing depositors. It is based on this that this study in line with agency theory suggests that there can be a positive correlation between the independence of the board and the financial results of the Bangladeshi banks and the risk-management performance.

Hypothesis 1a: The percentage of independent directors in the board is positively correlated with the financial performance of Bangladeshi banks.

Hypothesis 1b: The percentage of independent directors in the board is positively correlated with the risk-management performance of Bangladeshi banks.

Moreover, an overview of the current literature demonstrates that the Audit Committee is assumed to perform the role of risk guard of enterprise. Nevertheless, such committees often do not provide this protection in actual practice, which is explained, in large part, by a clear lack of particular financial experience of the members of such committees (Islam et al., 2021). The BSEC Code of Corporate Governance 2012 also lays much emphasis on audit committee independence besides board independence. The code stipulates that a listed institution should constitute an audit committee of three members with at least one being independent directors hence the importance of independent directors to protect everyone's interests. Between the independence of the audit-committee and quality of financial reporting, a positive relationship was found. (Akhigbe and Martin 2006). Kallamu and Saat (2015) discovered that between the independence of the audit-committee and the profitability of financial companies, there was a significant positive correlation. In fact, independent directors present on the audit committees may raise the effectiveness of the monitoring of the internal-control systems, thus leading to the improvements of the performance and risk-management performance of companies. This paper thus postulates on the ground of the argument of the agency theory that the independence of the audit-committee positively correlates with the financial performance and the risk-management performance of the Bangladeshi banks.

Hypothesis 2a: The percentage of independent directors in the audit committee is positively correlated with the financial performance of Bangladeshi banks.

Hypothesis 2b: The percentage of independent directors in the audit committee is positively correlated with the risk-management performance of Bangladesh banks.

METHODOLOGY

The current research relies on a sample of all 36 listed banks in the Dhaka Stock Exchange (DSE) out of a total 58 commercial banks in Bangladesh. The dataset includes audited corporate governance disclosures and financial statements that are relevant to the fiscal year 2023.

The intention of this research is to examine the connection between board independence and company performance, where risk performance and financial performance are considered in banks in Bangladesh. In this investigation, the two simple least squares (OLS) regression models, as shown in Table 1, are used to evaluate the relationships between explanatory variables and company performance measures.

Table 1. Regression Models

Model 1 $ROA = \beta_0 + \beta_1 BIND + \beta_2 AIND + \beta_3 CSIZ + \beta_4 AGE + \epsilon$

Model 2 $CAR = \beta_0 + \beta_1 BIND + \beta_2 AIND + \beta_3 CSIZ + \beta_4 AGE + \epsilon$

(Source: Self)

Table 2 outlines the independent variables, dependent variables and control variables, as well as the symbols that were used in this research. The dependent variables are Return on Assets (ROA) and Capital Adequacy Ratio (CAR), which are the indicators of financial performance and risk-management performance respectively. Table 2 gives the variables contained in Models 1 and 2.

Table 2. Research Variables Definition

Variable	Symbol	Definition
Dependent Variables		
Return on Assets	ROA	Net Income after Tax/ Total Assets
Capital Adequacy Ratio	CAR	Tier one Capital+ Tire two capital/Risk weighted assets
Independent Variables		
Board Independence	BIND	% of Independent Directors to total number of Board Members
Audit Committee Independence	AIND	'1' if the Chairman of Audit Committee is Independent Director, otherwise '0'
Control Variables		
Company Size	CSIZ	Log of Total Assets
Company Age	CAGE	Number of Listing Years

RESULTS AND DISCUSSION

Table 3 presents the descriptive statistics of the dependent variables, the independent variables and the control variables of the current study. Board Independence (BIND) has a mean of 21.01% with a range of 0.00% to 66.67% meaning that on average, 21.01% of the directors of the board are independent in Bangladesh banks. The average score of the independent director made the position of chairman of the audit committee (AIND) is 0.31, which means that 31 per cent of the sampled institutions adhere to the requirement of the Bangladesh Securities and Exchange Commission (BSEC) Code of Corporate Governance by appointing an independent chairman. The mean of the logarithm of total assets of the 36 banks is 10.88 (SD=1.22) and the mean listing age of the sample companies is 27.94 years, with the highest and lowest listing age of 10 and 64. The sample institutions have a mean return on asset (ROA) and capital adequacy ratio (CAR) of 1.22 and 0.45, respectively.

Table 3. Descriptive Analysis of Variables

Variable	Obs.	Mean	Std. Dev.	Min	Max
BIND	36	21.01455	10.4864	0	66.66667
AIND	36	0.305556	0.467177	0	1
CSIZ	36	10.87588	1.216713	5.760528	11.86508
CAGE	36	27.94444	11.96649	10	64
ROA	36	1.226717	2.07701	-0.0527	8.6
CAR	36	0.449736	1.570332	-1.5182	7.42

Table 4 presents the Pearson correlation outcome of independent and control variables. The correlation coefficients of the variables are less than 0.50. Thus, the regression analysis does not have substantive

multicollinearity issue in the study when looking at the correlation between board independence, risk management, and company performance.

Table 4. Multicollinearity & Correlation Analysis

	BIND	AIND	CSIZ	CAGE
BIND	1			
AIND	-0.2312	1		
CSIZ	-0.2829	0.0801	1	
CAGE	-0.126	-0.1962	0.0834	1

Table 5 shows the regression findings that were employed to study the correlation between board independence and financial performance (Model 1: ROA) and Table 6 presents the regression findings that were employed to study the correlation between board independence and risk management performance (Model 2: CAR) of Bangladeshi banks. Model 1 has adjusted R Squared of 0.0246, which indicates that the models explain 2.46 per cent of the cross-sectional variability in the outcome variables and the adjusted R Squared of Model 2 is -0.1048, which indicates that the models explain 10.48% of the cross-sectional variability in the outcome variables. The outcome of the analysis is not indicating a statistically significant association between BIND ($P > 0.10$) and ROA or AIND ($P > 0.10$) and ROA, which means that the presence of independent directors does not have an impact on the financial performance of Bangladeshi banks. This result is consistent with other researches conducted by Rashid et al. (2010) that suggested that outside directors have no consequence on the economic performance of Bangladeshi listed organizations. In addition, the findings indicate that the correlations of BIND ($P > 0.10$) with CAR and AIND ($P > 0.10$) with CAR are not significant either, which means that independence of the board has a weak effect on risk management practices.

Table 5. Regression Analysis of Model 1

Source	SS	df	MS		Number of obs	36
					F(4, 31)	1.22
Model	20.5453024	4	5.13632559		Prob > F	0.3221
Residual	130.443738	31	4.20786252		R-squared	0.1361
					Adj R-squared	0.0246
Total	150.98904	35	4.31397258		Root MSE	2.0513
ROA	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
BIND	-0.0137407	.0357781	-0.38	0.704	-0.0867106	0.0592292
AIND	-1.168531	.7848571	-1.49	0.147	-2.769258	0.4321954
CSIZ	0.0736746	.2976088	0.25	0.806	-0.5333025	0.6806518
CAGE	0.0357881	.0300846	1.19	0.243	-0.0255699	0.0971461
_cons	0.0711667	3.636909	0.02	0.985	-7.346358	7.488691

Table 6. Regression Analysis of Model 2

Source	SS	df	MS		Number of obs	36
					F(4, 31)	0.17
Model	1.85414881	4	.463537203		Prob > F	0.952
Residual	84.4538856	31	2.72431889		R-squared	0.0215
					Adj R-squared	-0.1048
Total	86.3080344	35	2.46594384		Root MSE	1.6506
CAR	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
BIND	-0.0160105	.0287883	-0.56	0.582	-0.0747246	0.0427035
AIND	0.2350173	.6315225	0.37	0.712	-1.052981	1.523016
CSIZ	0.0154624	.2394661	0.06	0.949	-0.4729319	0.5038566
CAGE	0.0033848	.0242071	0.14	0.89	-0.0459859	0.0527556
_cons	0.4516241	2.926379	0.15	0.878	-5.516766	6.420014

Therefore the empirical test shows, that the ratio of the independent directors and the financial performance of the sampled institutions stands in a statistically insignificant relationship. Similarly, no meaningful correlation was found between board independence and development of risk management practices. These results comply with the hypothesis of inefficiency proposed by Rashid (2018), who argues that independent directors are sometimes unable to exercise the necessary authority or motivation to conduct effective monitoring in Bangladesh.

Often the independent directors are chosen through the same major shareholders that the directors are supposed to be independent of, hence creating a conflict of loyalty. (Mamun & Azhar, 2019). According to Islam et al. (2021), the successful process of risk management in banking institutions requires technical expertise. The capability of independent directors to supervise complex credit risks is significantly reduced when they are chosen on political grounds instead of basing their selection on their technical skills. Moreover, the BSEC Corporate Governance Code provides that the independence be maintained, but in most instances, this is limited to a mere formality. The recent increase in non-performing loans and loan-scam cases in both state-owned and privately-owned banks suggests that the board control has not been able to keep excessive risk-taking in check.

CONCLUSION

This paper finds that the simple implementation of the independent director appointment does not have a substantive performance and risk management outcome of Bangladeshi banks. The current system of governance seems to be more of a figurative exercise than a substantive process.

To improve the efficacy of corporate governance, the qualification standards should be such that the independent directors must have a certain amount of experience in the industry and that they must be financially literate. The inclusion of a minority shareholder consent system regarding appointment of independent directors would also reduce the impact of the controlling families. Moreover, stricter punishments should be imposed on boards failing to prevent major financial anomalies.

The next round of study ought to focus on the qualitative aspect of board discussions especially the rate of dissent in meeting minutes to gain a better idea of the internal dynamic of Bangladeshi banks corporate boards.

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