Corporate Governance Status in the Banking Sector of Bangladesh: A Comparative Study

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Abstract

Good corporate governance is instrumental to effective functioning of any organization, which aligns the corporate practices with the long-term objectives of the organization. Recent studies on corporate governance in the banking sector of Bangladesh have identified transparency, accountability, risk management, political influence, and direct influence of the directors and owners to be the core issues to analyze the corporate governance. This study attempts to critically examine the corporate governance status in the banking sector of Bangladesh, making a comparison of profitability and asset quality among three banking groups: state owned commercial banks (SOCBs), private commercial banks (PCBs) and foreign commercial banks (FCBs). The findings of the research depict that the FCBs demonstrate higher average return on equity (ROE) and lower level of average Non-Performing Loan (NPL) ratio whereas the SOCBs face the lowest average ROE and the highest NPL ratio on an average. However, the PCBs show lowest average NPL ratio along with the higher ROE than SOCBs. The study concludes that FCBs demonstrates better policy formulation and execution of standard corporate practices to protect the wealth of the shareholders than PCBs and SOCBs do. In light of the findings, the study suggests that proper documentation, effective auditing and stricter borrower selection criteria, training of the personnel and capacity enhancement are must for the SOCBs to keep its corporate governance practice up to the marks. The same applies to PCBs to regain the public trust.

Keywords: Corporate Governance, Foreign Commercial Banks, Non-Performing Loan, Private Commercial Banks, Return on Equity, Risk Management, State-owned Commercial Banks.

1. INTRODUCTION

Banks play one of the most important and crucial role in the economic and financial development for any economy. Particularly, economies with underdeveloped capital market, like the one in Bangladesh, depend highly on banks and banking system for financial intermediation, one of the major roles of financial institutions, which is channeling funds from the surplus unit to the deficit unit in an efficient manner (Ahmed et al., 2017). Therefore, bank performance attracts significant attention from public and financial regulators as banks are critical institutions in most economies (Stankeviciene et al., 2012). The more the banks flourish and do the business successfully, the more the economy starts to flow with enough resources to enhance
the economic condition of the country. Banking business involves in borrowing money from the public, mainly in the form of deposit and borrowing from other institutions, and lending money to deserving creditworthy individuals and entities at higher interest rate to earn the spread. Since the major source of bank fund is the public money, it must be regulated under strict rules, laws, acts and regulations ensuring accountability, transparency, compliance and above all, good corporate governance practice. The essence of good governance system is mandatory for stable and resilient banking system. Corporate governance failure has a direct and enormous effect on bank failure. Most of the bank failures result from not having sound and good corporate governance practice (Berger et al., 2016). Corporate governance failure has always resulted in massive problems since it is inseparable from efficient and effective organizational functioning. Recent studies on corporate governance in the banking sector of Bangladesh have demonstrated many contemporary problems. Transparency, accountability, risk management, political influence and the relationship of the performance with the direct influence of the directors and owners have become the core issues to analyze the corporate governance.

In developing economies, state owned and commercial banks lack good corporate governance practices which is reflected in their profitability and Non-Performing Loans (NPL) ratio (Millon, Jamie, Nutt, & Tehranian, 2009). Corporate governance elucidates the transparency, accountability and regulation resulting in overall good performance for the banks, whereas the banks having poor governance lack accountability and transparency in presentation and reporting. One of the main reasons behind this phenomenon is the pressure, especially with political influence, for disbursing unwanted loans to the creditors with substandard creditworthiness. Foreign bank, as directed, managed and governed by their global bodies, used to maintain good corporate governance practices which is also reflected by its profitability and NPL ratio.

In Bangladesh, various researches have already been conducted showing the direct relationship of corporate governance status with profitability and NPL ratio. Hence, NPL ratio and profitability can be considered as a final outcome of corporate governance. Thus, NPL ratio and profitability can be used as a tool to measure governance in banks to differentiate between banks practicing good or poor corporate governance as well (Gerald Vinten, 2001). Though there has been a lot of researches that establishes a strong relationship between corporate governance with asset and profitability, no research has shown the relative status of corporate governance among the three bank groups operating here; namely Private Commercial Banks, Foreign Commercial Banks and State-owned commercial banks.

The general and primary objective of the study is to show the corporate governance status in the banking sector of Bangladesh. This research aims to show the corporate governance status in the banking sector of Bangladesh, making a comparison among three bank groups: SOCBs, PCBs and FCBs with the help of NPL ratio and Profitability. The specific objectives are-
i. To measure and compare the asset quality among the industry groups.
ii. To measure and compare the profitability among the industry groups.
iii. To compare the risk management process among the industry groups.
iv. To assess the influence of third party in credit approval process among the industry groups.

Bangladesh Bank has set some guidelines for all kinds of commercial banks in Bangladesh. All commercial banks must have to follow those guidelines. Good corporate governance helps an organization to utilize the resources in a proper way. On the other hand, good corporate governance ensures the best use of all the opportunities that come in the way of an organization. This study shows the present corporate governance scenario of the banking sector in Bangladesh. However, the crucial factor is that the corporate governance can portray the current and future probability of success of the bank in a widespread area.

2. LITERATURE REVIEW

Corporate governance refers to the methods, policies and process through which the operation of an organization is conducted. Corporate governance is important for efficient management and in achieving the goals of the organization which has direct impact on the stock value. The rules, policies and structure through which an organization operates and direct itself is referred to as corporate governance. Corporate governance specifies policies and structure for accomplishing various task within the organization. Corporate governance which includes laws and regulations under which an organization operates has great influence the equity price of the company (Gompers, 2013). Corporate governance includes both internal policies and laws of the country which an organization must follow for conducting its operation in a particular region. In a research it has been found that corporate governance serves as a protection tool for the investors (La Porta, 2014).

The Sarbanes Oxley Act of 2002, in USA, ensures the accountability of public companies and their regulatory visibility. According to Sarbanes Oxley Act (2002), the CEO and CFO of any public limited company will be liable personally for the records of the company and the organization must disclose any information or event affecting share price immediately. There are some laws for ensuring corporate governance in Bangladesh. Bangladesh Securities Exchange Commission has published a corporate governance code in which many things related to corporate governance has been identified. Some of the rules are as follows- 1) Board members of an organization must be between 5 (five) to 20(twenty) members 2) 1/5th of total members of board should be independent director 3) Independent directors should have relevant qualifications and good knowledge on financial laws 4) The CEO and Chairperson of Board should be different individual and CEO of the company should not be CEO or managing director of another company listed in stock exchange. 5) Directors should report the shareholder the outlook of the industry, risk associated, discuss extraordinary events and items and should provide explanation of deterioration of financial result after Initial Public Offering and Repeat Public Offering etc. (Corporate Governance Code, BSEC, 2018).
Corporate governance in the banking sector is urging for transparent and accountable picture and the banks are highly recommended to be well organized in the management sectors to ensure the accountability and implement the ethical requirements. In a seminar of International Finance Corporation and Japan-Bangladesh Chamber of Commerce and Industry organized on 18th February 2019, it was opined that corporate governance must be ensured to attract foreign investment. In government banks and some commercial banks, there are huge non-performing loan which are mainly due to not following corporate governance (“Collapse of Banks’ Corporate Governance”, The Daily Star, 2018). According to Wise and Ali (2009), it was opined that almost all sector is dependent on banking sector and thus to ensure good functioning of the economy of Bangladesh corporate governance must be ensured in government banks, commercial banks and foreign banks (Wise, 2009).

In a paper of Gerald Vinten (2001), it was found that the reasons behind the failure of Enron was fault in corporate governance. In Enron, the board of directors and the audit committee were misled by the CFO Adrew Fastow and by using accounting loopholes debts were understated which deceived shareholders (Gerald Vinten, 2002). In case of Hall Mark scam also it can be found that a branch of Sonali Bank provided $344 million of loan based on scam document on which the CEO of Hall Mark was involved. In case of Bismillah group with the help of officials of Janata Bank, 9.9 billion tk of fund was embezzled (“Tk 9.9bn Scam by Bismillah Group”, Dhaka Tribune, 2013).

In a Paper of Bala (2018), it was shown that policies have been taken to ensure four pillars of corporate governance - fairness, accountability, responsibility and transparency in all listed companies of Bangladesh. In the new corporate governance code, 166 conditions exist where 28 previous conditions have been reformed and 62 new conditions has been incorporated. In the new policy, disclosure of risks to the shareholders and the structure of board of directors and qualification of independent directors has been emphasized. No regulation has been made about size of board of directors of financial institution but qualification of independent director has been changed. Those connected with company subsidiary or associate of the company is not capable of being independent director (Bala, 2018).

According to Allen N. Berger, George R. G. Clarke and others (2005), the corporate governance of a commercial bank is highly related with the Non-performing loan structure of the bank. The improvement of the bank is depended on the constructive maintenance of the non-performing loan. However, Akpan, Emmanuel and Hodo (2012) asserted that banks that follow a well-organized transparent and lucid financial statements and activities to the stakeholders are in profitable position and there is a higher correlation between bank’s profitability and good corporate governance than between asset value and profitability. On the other hand, the banks are prone to be following earning management to improve their profitability. Millon, Jamie, Nutt and Tehranian, (2009) reviewed that the banks having earning management are being signaled by some red flags like revenue recognition, cost reduction without any valid
consideration etc. and the governance of the banks can be reflected by the profitability that has less earning management signals. So, the banks’ corporate governance can be analyzed by the implication of the Non-performing loan and profitability measure like ROE. With this perspective, Akpan, Emmanuel and Hodo (2012) explained that the banks having high ROE would have lower NPL resulting in higher corporate governance. Therefore, they concluded that profitability and NPL structure can be taken as a measure to assess the corporate governance status since profitability and NPL structure is the final outcome of corporate governance status.

Based on the previous research findings, this study tries to assess the corporate governance status in the banking sector with ROE (as a measure of profitability) and NPL Ratio as tool to measure corporate governance since these two indicators have been proved to be the final result of good or poor corporate governance practice. With the help of these two parameters, this study also differentiates among three banking groups based on the corporate governance status.

3. RESEARCH METHODOLOGY

Aligned with the objectives of the research to delve into corporate governance reality in the banking industry of the country, both primary and secondary sources of data have been collected, summarized and analyzed in this study. To understand the asset quality and profitability of the banking industry of the country, the time series data of NPL and ROE have been collected from Bangladesh Bank’s (the central bank of Bangladesh) website and the annual reports of the scheduled commercial banks operating in the country. The data have been analyzed grouping the banks into three categories for conducting comparative analyses.

A structured questionnaire survey has been conducted for the research purpose. A stratified sample of 232 respondents from 58 banks were chosen. The representation of each category of banks (state owned commercial bank, private commercial bank and foreign commercial bank) was proportionate to their actual number. Participants of the survey were asked to rate their opinion to 6 (six) statements stated in the questionnaire in a likert scale of 1 (one) to 5 (five); 1 being strong disagreement and 5 being strong agreement with the statements. Based on the collected data set, independent sample t-tests were run to test the hypotheses. Both Microsoft Excel Analysis Tool Pack and IBM SPSS were used to analyze the data.

Finally, a focused group discussion was conducted where the management personnel of scheduled commercial banks actively participated. The discussion was moderated by the authors. The qualitative information unraveled from the discussion helped to answer the research questions.

4. FINDINGS

4.1 NPL and ROE Analysis

One of the critical indicators of the performance of the banking industry is the quality of the assets i.e. the loans and advances. The lending portfolio of the banks are
categorized into two groups; classified and unclassified. The interest earnings on the classified loans are suspended until the loans are unclassified again. The healthier the quality of assets in a bank, the less the percentage of non-performing classified loans in the lending portfolio of the bank. From the reliable secondary sources, historical time series data on NPL ratio of scheduled banks have been collected for the purpose of comparison.

The state-owned commercial banks have had the highest non-performing loan ratio over the last 5 (five) years. The upward slope of the NPL graph explains the gradual deteriorating financial condition of the SOCBs. In 2018, the gross NPL in this category was 30%. The foreign commercial banks however have improved their asset quality over time. They brought down the Gross NPL to 6.5% at the end of December, 2018 from 5 (five) year high NPL 9.6% of 2013. Although private commercial bank’s non-performing loans are significantly lower than that of state-owned commercial banks, their non-performing loan increased by 600 basis point in the last five years from 4.9% in 2014 compromising the quality of asset.

Since as a financial intermediary, commercial banks collect money and invest them while maintaining the Cash Reserve Ratio (CRR) and Statutory Liquidity Reserve (SLR) ratio instructed by the central bank, the industry is highly leveraged of which almost 90% of the funds comes either from deposits or from non-deposit borrowings in comparison to only 10% of funds coming from equity sources. The profitability of this industry is largely affected the leverage ratio (magnifying both upside and downside risk). A comparison of ROE of three categories of banks depicts the profitability performance of each group.
4.2 Hypotheses Testing

As a part of the research, a structured questionnaire survey, participated by the banking professionals, has been conducted. The respondents were asked to rate their agreement to each of the seven statements on a scale of 1 to 5; 1 being the strong disagreement and 5 being strong agreement. For each of the statements, two sets of hypotheses have been developed and tested based on the primary data collected. The first set of hypotheses were:

- \( H_0 \): The mean score of the PCBs is less than or equal to the mean score of SOCBs.
- \( H_A \): The mean score of the PCBs is greater than the mean score of SOCBs.

The second set of hypotheses were:

- \( H_0 \): The mean score of the FCBs is less than or equal to the mean score of PCBs.
- \( H_A \): The mean score of the FCBs is greater than the mean score of PCBs.

For each set of hypotheses independent sample t-tests were run assuming the equal variances. The level of significance for each hypothesis test is 5%. The statistical summary of the t-tests has been detailed below.

**4.2.1 Strict Credit Policy for Loan Sanctioning**

The respondents were presented the statement ‘We have strict credit policy in place for loan sanctioning’. Every respondent rated the statement on a scale of 5. The
mean scores for SOCBs, PCBs and SOCBs are 1.5, 3.51 and 4.67 respectively. The standard deviations are 0.18 for SOCBs, 0.079 for PCBs and 0.167 for FCBs.

For the first set of hypotheses, the t-value stood at 10.19 with a degree of freedom of 47. The p value is 0.00001%. At 5% level of significance we reject the null hypothesis that the mean value of PCB is less than the mean value SOCBs implying the perception of stronger credit policy in private commercial banks. For the second phase of hypothesis testing, the t-value stood at 6.209 where degree of freedom was 48. For one tailed t-test, the p value is 0.000001%. As a result, we reject the null hypothesis at 5% level of significance.

4.2.2 Delegation of Credit Approval

The second parameter of questionnaire survey was to quantify the extent of delegation of credit approval authority to the employees down the hierarchy line. In the foreign commercial banks, this delegation is highest followed by private commercial and state-owned commercial banks. The mean scores for this parameter was 1.375 for SOCBs, 3.46 for PCBs, 4.7 for FCBs. The standard deviations were 0.18, 0.07 and 0.167 respectively.

To identify the significant statistical difference, one tailed t-test was conducted on two set of hypotheses. The first two hypotheses compared the mean score of PCBs and SOCBs. The t-statistics value was 10.67 and p-value for one tailed test is 0.000000001%. At 5% significance level, the null hypothesis was rejected. In the second phase, the mean scores of FCBs and PCBs were compared. With a degree of freedom of 48, the t-value was determined as 6.48. At 5% level of significance, the null hypothesis was rejected.

4.2.3 Regularity of Training the Approvers

Regular training of the credit approvers keeps them updated with the recent changes of industry, the advanced techniques of borrower assessment and macro-economic reality of the country. It brings in insights and efficiency as well. The respondents were asked to rate the statement ‘Regular Training Facility is provided to the credit approvers’ on a scale of 5. The mean score for State-owned commercial bank was only 1.125 where the PCB’s average score was 3.53 and FCB’s score stood at 4.56. The standard deviations were only 0.125, 0.07 and 0.175 respectively. It implies the agreement data distribution is not widely dispersed.

The mean scores of PCBs and SOCBs were compared in the first phase. The t-value was 12.85 at 95% level of confidence and p value for the test statistics approximately 0.00000001%. At 5% level of significance, the one-tailed null hypothesis was rejected. The PCBs conduct more regular training than the SOCBs. In the second phase, the null hypothesis was that the mean score of regularity of training is less than or equal to that of PCBs. The t statistics value was 5.44 where the degree of freedom was 48. For one tailed t-test, the probability associated with test statistics was 0.0001%. At 5% level of significance, the null hypothesis was rejected.
4.2.4 Absence of Undue Influence on Loan Sanctioning

The increasing Non-performing loans give rise to the question where the undue influences on the bank management is being exercised. Several big scale default cases show the sign of pressure from the board on the management to compromise the standard operating procedure. Such an involvement is a grave threat to the corporate governance of the company. The respondents were asked to rate the extent of absence of undue influences in the bank. The mean score for State-owned commercial bank was only 1.5 where the PCB’s average score was 3.46 and FCB’s score stood at 4.78. The standard deviations were only 0.18, 0.07 and 0.14 respectively.

The t-statistics value for the first set of hypotheses is 9.97 with a degree of freedom of 47. The probability associated with the test statistics is close to 0.0001%. At 1% level of significance, the null hypothesis is rejected. For the second phase, the t-value stood at 7.21 with 95% confidence level. At 5% level of significance, the one-tailed null hypothesis has been rejected.

4.2.5 Due Diligence of Credit Administration Department

The credit administration department is said to be the last gatekeeper of a loan. They conduct due diligence on the submitted documents. In future when a borrower defaults, the proper documentation provides better legal ground for the bank against the defaulter. Unless the due diligence is conducted by credit administration department on the documents before the disbursement of the loan, recovery of the loan amount from the borrower and personal guarantors become difficult for the bank. The respondents were presented the statement ‘Due diligence conducted by Credit Administration Department is strict’. The SOCBs showed disagreement with the statement where the average score is 1.875 with a standard deviation of 0.125. On the other hand, the mean scores for PCBs and FCBs are 3.5 and 4.44 where the standard deviations are 0.07 and 0.175 respectively.

At 5% level of significance both sets of null hypotheses were rejected. It implies that the foreign commercial banks’ credit administration department conducts stricter due diligence on loan documentation than the private commercial and state-owned commercial banks.

4.2.6 Weight of Portfolio at Risk on Key Performance Indicator

The performance of the employees is quantified by the key performance indicators (KPI) and weight of the parameters of KPI indicates the importance of function on the entire job role. The more weight on the portfolio at risk makes the credit approvers and relationship officer more cautious about the borrower selection because overdue from the client will decrease their performance rating at a greater magnitude. The portfolio at risk and non-performance loan ratio are seen to be given different weightage on KPI among different banks. The mean score of the SOCBs in the statement of KPI weightage was 1.125 and the standard deviation was 0.125. The PCB’s average score for the same statement stood at 3.39 and for FCBs it was 4.44. The standard deviations are 0.07 and 0.175 respectively.
The first null hypothesis was the mean score of the PCB is less than or equal of that of SOCBs. The t value for 95% confidence interval was 12.32 where the degree of freedom is 47. At 5% level of significance, the null hypothesis was rejected. The second null hypothesis was that the mean score of the FCBs is less than that of PCBs. The t-statistics value stood at 5.73 with p-value for one tailed t-test of 0.00003%. At 5% level of significance, the second null hypothesis was rejected as well.

4.3 Focused Group Discussion Analysis

In the focused group discussion, different managers have gathered to discuss on the corporate governance and some factors affecting the corporate governance status for the banking sector in Bangladesh came to light. Some attendants agreed that one of the major factors that have direct impact on the corporate governance issues is Proper Credit Policy and Borrower Selection Criteria. They discussed on the disbursement of credit to the borrowers focused that while disbursing credit this policy must mandatorily be maintained, irrespective of the creditor asking for loan, the loan sanction decision must be based upon the selection criteria delineated in the policy. But, in many cases, it has been seen that the credit policy is vague and sometimes is not maintained strictly which results in unwanted borrower selection and loan sanctioning. This factor is the worst for the SOCBs in Bangladesh. However, the attendants also argued that influence of management, in most cases, is generally more severe and needs to be sanctioned by the manager’s approval. The managers are sometimes nepotistic and they, without considering the loan criteria, give loans to the third party that may increase the NPL. However, in case of Bangladesh, this is the case in state-owned banks and less seen in the foreign banks. On the other hand, the managers responded that in case of sanction advice dilemma in the banks, the bankers often face the dilemma of whether to give the sanction of a loan and the advice may become unfavorable for the banks but due to political influence and other factors, it leads the banks to make false decision that is a common phenomenon in the state-owned banks. The attendants discussed most on the political influence as different political parties often hold undue influence on the banks to make sanction of the loan to a particular party without the consent of the bank and guidelines. If the party is a defaulter by nature or if he has the potentiality to default, the banks may become jeopardized and the Know Your Customer (KYC) will become invalid. In case of commercial banks, it its less seen but in state-owned banks, it is a common occurrence every day.

The unhealthy competition and risky investment were also a crucial discussed topic and by investing in highly risky project will increase the chance of high return but in case of failure, there will be a huge loss which cannot be borne by the banks. It was argued that in Bangladesh, the PCBs are facing a huge competition as there are more banks in the market than needed which in turn influencing them to get involved in unhealthy competition and disbursing risky credit and investment. This has been a common phenomenon for the commercial banks and so, the loss of the project can decrease the ROE. The bankers suggested that a bank having a lower valued mortgage
or an incomplete mortgage may lead to the default of the loans and its recovery may not be sufficient to recover the NPL. However, the improper mortgage may end the banks loan providing power such as for the state-owned banks that are focusing on the loan giving and not in the mortgage selection criteria and so having a strict formula in the foreign banks, those banks are enjoying lower NPL and higher ROE compared to the state-owned banks. It is an irony of fact that in Bangladesh, there are adequate rules and regulation for governing the banks. Moreover, Bangladesh Bank issues circular from time to time for smooth functioning of the PCBs. But it is seen that frequent changes in the government regulation hampers the overall functioning of the PCBs. Apart from that, it has been found for so many times- PCBs are ignorant of many circulars issued by Bangladesh Bank which is so unexpected for the banking sector. Moreover, fund diversion has become common phenomenon in Bangladesh. As funds are credited to the creditor’s account, they may not use the fund for the purpose shown to the banks. Lack of proper monitoring and supervision is primarily responsible for this irregularity. Besides, step by step fund disbursement should be enforced to prevent fund diversion. As SOCBs lack supervision and monitoring the most, they suffer most from this irregularity as well.

5. CONCLUSION

In Bangladesh, the banking sector lacks prudential regulations. Adequate supervision and care should be given for corporate governance on a priority basis to provide a safety net for the depositors and stakeholders of the banks. Except for the FCBs and few PCBs, most of the banks do not have quality credit analysis and asset management practices. The study suggests that proper documentation, efficient auditing, and disbursement of credit to good borrowers maintaining the credit policy strictly must be followed mandatorily for the SOCBs to keep its corporate governance practice up to the marks; whereas the PCBs are expected to follow the guidelines of corporate governance for ensuring accountability and regaining social trust. However, both the SOCBs and PCBs should acquire extensive analytical capabilities in credit analysis. Also, all the other factors discussed in this study should be critically evaluated and examined in order to establish improved corporate governance system, culture and practices to reshape and reaffirm good corporate governance status for strengthening the banking sector and reinforcing public trust in this sector.
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