DETERMINANTS OF THE FINANCIAL PERFORMANCES OF COMMERCIAL BANKS IN ETHIOPIA: FROM INTERNAL CORPORATE GOVERNANCE PRACTICES PERSPECTIVE

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ABSTRACT

The purpose of this study is to examine the determinants of the financial performances of commercial banks in Ethiopia from an internal corporate governance practices perspective using time series data covering the period of 2008-2013. In the study, financial performance is measured by ROA and ROE of the banks. The study finds that qualified directors in the board, directors with prior experience in banking, chief executive officer compensation and existence of risk management committee in the board have a **statistically significant and positive effect on banks' performance in terms of both ROA and ROE; whereas** ownership dispersion has a statistically significant and negative effect on banks performance. The effect of frequency of board meeting on financial performance of bank is positive and significant in terms of ROA, but significant and negative in terms of ROE. On the other hand, variables such as board size, female director in the board, and the existence of audit committee in the board did not have a statistically **significant effect on bank's performance.**

Keywords: Determinants, Internal Corporate Governance, Financial Performance, Commercial Banks

INTRODUCTION

Several events are responsible for the heightened interest in corporate governance especially in both developed and developing countries like Ethiopia. Jensen and Meckling (1976) acknowledged that the principal agent theory which was also adopted in this study is generally considered as the starting point for any debate on the issue of corporate governance. A number of corporate governance mechanisms have been proposed to ameliorate the principal agent problem between managers and their shareholders. These governance mechanisms as identified in agency theory include board size, board composition, CEO pay performance **sensitivity, directors' ownership and shareholder** right (Gomper, Ishii and Metrick, 2003). However, corporate governance of banks in developing economies as it relates to their financial performance has almost been ignored by researchers.

The relevance of corporate governance in **today's world cannot be suppressed, as it is a** central and dynamic aspect of business. It **enhances firms' performance** as well as competitiveness and is a royal route to achieve excellence in business. Banks and other financial **intermediaries are at the heart of the world's** recent financial crisis. The deterioration of their asset portfolios, largely due to distorted credit management, was one of the main structural sources of the crisis (Fries, Neven and Seabright, 2002). To a large extent, this problem was the **result of poor corporate governance in countries'** banking institutions and industrial groups. Moreover, conflict of interests between different stakeholders is potentially high in banking sector. Ciancanelli and Gonzales (2000) argue that banking sector has different market structures, which do not meet the basic

assumptions of agency theory. Besides unusual agency problems, bank managers and owners are subject to the regulation. Although regulation is concerned about governing risk management in banking sector; literatures in financial banking have no clarity to explain the relationship between corporate governance practices and regulation and how the relationship will lead to higher bank performance. This study, therefore, seeks to fill the gap by providing full information about internal corporate governance practices and financial performance of commercial banks in Ethiopia. The study used panel data collected from all commercial banks in operation from the years 2008 to 2013.

LITERATURE REVIEW

Review of Theoretical Literature

Several theories exist that attempt to highlight the objective of the firm and how the firm should be responsible in meeting its obligations. This study looked at three main theories that have influenced corporate governance development.

According to Freeman, Wicks, and Parmar (2004), Stakeholder Theory basically aims at striking a balance between the interests of a corporation's stakeholders and their satisfaction. They define stakeholders as any group or individual who can affect or is affected by the achievement of the organization's objectives. Sundaram and Inkpen (2004) also suggest that stakeholder theory attempts to address the question of which groups of stakeholder deserve and require management's attention. They explained that all person or groups with legitimate interests participating in an enterprise do so to obtain benefits and that there is no prima facie priority of one set of interests and benefits over another.

The Stewardship Theory takes its origin from psychology and sociology. Davis, Schoorman, and Donaldson (1997, pp. 20-47) define it as the protection and maximization of shareholders' wealth by a steward through firm performance because by so doing, the steward's utility functions are maximized. Based on their views, a steward is an executive or a manager of a company who is duly charged with the responsibility of protecting shareholders' interests. Whereas agency theorists view executives and directors as self serving and opportunistic, stewardship theorists, reject agency assumptions, suggesting that directors frequently have interests that are consistent with those of shareholders.

The Agency Theory has its roots in economic theory and it dominates the corporate governance literature. Daily and Dalton (1992, pp.375-386), point to two factors that influence the prominence of agency theory. Firstly, the theory is a conceptually simple one that reduces the corporation to two participants, managers and shareholders. Secondly, the notion of human beings as self-interested is a generally accepted idea. In its simplest form, agency theory explains the agency problems arising from the separation of ownership and control. It provides a useful way of explaining relationships where the parties' interests are at odds and can be brought more into alignment through proper monitoring and a well-planned compensation system (Daily and Dalton, 1992).

Review of Empirical Literature

Economic and financial theory suggest that the instruments mentioned below affect the value of a firm in developing and developed financial markets.

Board size has economic explanation that enables the board of directors to ensure its proper functioning which affects the value of a firm. Pearce and Zahra (1992) suggest that a larger board has a range of expertise to make better decisions for a firm as the Chief Executive Officer (CEO) cannot dominate a bigger board because the collective strength of its members is higher and can resist the irrational decisions of a CEO. On the other hand, Ranti and Samuel (2012, 11-15) state that large boards affect the value of a firm in a negative fashion as there is an agency cost among the members of a bigger board. Therefore, based on the above discussion the following hypotheses are advanced:

HP1: There is a significant negative relationship between board size and bank performance.

The effect of the activity of a board yields either proactive or reactive results. Ntim and Osei (2011) found that there is significant and positive association between the frequency of corporate board meetings and corporate performance, implying that boards that meet more frequently tend to generate higher financial performance. By contrast Vefeas (1999), argues that normally the limited time directors spend together is not used for the meaningful exchange of ideas among

themselves thus frequent meetings might also be a result of board reaction to poor performance.

HP2: There is a significant positive relationship between the frequency of board meetings and bank performance.

There have been disagreements among the scholars regarding the presence of female directors in the board. Some have revealed positive relationships between financial performance and presence of female directors in the board Bonn (2004) and other study found that female director proportion has a negative relationship to the financial performance of the firms (Mentes, 2011).

HP3: There is a significant positive relationship between the proportions of female directors and bank performance.

Existing literature argued that higher education of top management directors in organizational contexts is positively related to receptivity to innovation, creativity, and better strategic decision-making. Poon, Heong and Lee (2013, pp. 42-46) found that there is positive relationship between performance and the qualifications of directors. Their finding supports the belief that top management teams who have qualifications in business-related disciplines such as marketing, management, finance, law or economics, improved higher banks performance. Drawing on this strand, the following hypothesis is stated:

HP4: There is a significant positive association between the qualification of directors with business backgrounds and bank performance.

The 'group think' cohort is a group of top managerial teams who have some relevant data in common such as socioeconomic background, employment and industry, societal experience, functional track, and training, and have been imprinted on its members and shaped their values and perceptions. Poon, *et al* (2013) analyzed all post merged domestic commercial banks in Malaysia and they state that directors with relevant business experience are significantly and positively associated with performance. Therefore, the hypothesis is posited as:

HP5: There is a significant positive relationship between degree of experience of directors and bank performance.

CEO compensation might also prove an effective mechanism to deal with governance problems. The conflicts of interest that emerge between CEOs and the shareholders they

represent are a classical example of the principal-agent problem (Crawford, Ezzell and Miles, 1995), and the primary means for shareholders to ensure that a manager takes optimal action is to tie his/her pay to the performance of the firm. In addition, Zhang and Yang (2011, pp. 13-19) pointed the fact that a significant positive relationship exists between executive compensation and bank performance. Therefore, based on this the following hypothesis is examined:

HP6: There is a significant positive relationship between higher level of executive's compensation and bank performance.

Literature distinguishes two main types of ownership structure: concentrated and dispersed ownership. Empirical studies on the effect of ownership on bank performance provide mixed results. Al-Hawary (2011) noted that ownership concentration has no statistically significant effect on bank performance. However, Antoniadis, Lazarides, and Sarrianides (2010 cited in Al-Hawary, 2011) found that existence of a statistically significant non linear relationship between ownership and performance, supporting the notion that agency problem in banks is different compared to other firms. Based on the above discussion the following hypothesis is developed:

HP7: There is a positive relationship between ownership dispersion and bank performance.

Waweru, Kamau andUliana (2008) state that market regulators, commissions and accountancy bodies have recommended the establishment of audit committees as an important step in improving corporate governance. The audit committee assists the board in fulfilling its oversight responsibilities by reviewing the financial information and internal control systems. As a liaison between the external auditor and the board, an audit committee bridges the information asymmetry between them, facilitates the monitoring process Klein (1998). Accordingly, based on the above arguments the hypotheses are advanced as:

HP8: There is a significant positive relationship between existence of audit committee in the board and bank performance.

Compensation and risk committees are important corporate governance mechanisms that protect shareholders' interests by monitoring management, including the provision of incentive payments to align the interests of

managers with those of shareholders. However, the mere existence of these committees does not ensure they will operate effectively. Menon and Williams (1994) argue that in many cases committees may be formed to promote the appearance of good corporate governance without serving any useful purpose for the organization. The risk management committee monitors the level of risk the firm is exposed to while keeping in mind the desire to maximize returns; advises the board on the firm's management of the current risk exposure; and future risk strategy (Walker, 2009). Risk management committee is a National Bank of Ethiopia(NBE) mandatory committee (CBE, 2012). In line with the above discussion, the following hypothesis is examined:

HP9: There is a significant positive relationship between existence of risk management committee in the board and bank performance.

MATERIALS AND METHODS

Data for the study were collected from audited financial statements of 10 banks (2 state and 8 private) which have been operating for the last six fiscal years. Data on internal corporate governance was obtained from each bank in the study Thus, this study used panel data of 10 commercial banks for six years.

The purpose of this study was to examine the determinants of the financial performance of Commercial Banks of Ethiopia from internal corporate governance practices perspective. A quantitative method of data analysis was employed for the study. Panel data methodology was adopted for the study. The collected panel data was analyzed using descriptive statistics, correlations and multiple linear regression analysis and inferential statistics by the help of e-view statistical software. The descriptive statistics was used to quantitatively describe the important features of the variables using mean, maximum, minimum and standard deviations. The correlation analysis was also used to examine the relationship between the dependent variable and explanatory variables. In addition, before conducting regression analysis, diagnostic tests are performed to ensure whether the assumptions of the CLRM are violated or not in the model. The study used ROE and ROA as a measure of bank performance. The study employed two models as:

Model 1: $ROA_{it} = \alpha + \beta_1 BSZ_{it} + \beta_2 lnNBM_{it} + \beta_3 PFD_{it} +$

$\beta_4 QUA_{it} + \beta_5 EX_{it} + \beta_6 CEOpay_{it} + \beta_7 OWD_{it} + \beta_8 AUC_{it} + \beta_9 RMC_{it} + \beta_{10} LEVE_{it} + \beta_{11} OWT_{it} + \varepsilon$ (1)

Model 2: $ROE_{it} = \alpha + \beta_1 BSZ_{it} + \beta_2 lnNBM_{it} + \beta_3 PFD_{it} + \beta_4 QUA_{it} + \beta_5 EX_{it} + \beta_6 CEOpay_{it} + \beta_7 OWD_{it} + \beta_8 AUC_{it} + \beta_9 RMC_{it} + \beta_{10} LEVE_{it} + \beta_{11} OWT_{it} + \varepsilon$ ……(2)

Where:

- ROA:- Returns on Asset
- ROE:- Returns on Equity
- BSZ_{it} is board size representing the total number of directors sitting in the board for bank i in time t;
- NBM_{it} is the total number of annual board meeting in the year for bank i in time t;
- PFD_{it} represents the percentages of female directors in the board for bank i in time t;
- QUA_{it} represents the percentage of qualified directors in the board for bank i in time t;
- EX_{it} represents the percentage of directors with prior experience in banking in the board for bank i in time t;
- $CEOpay_{it}$ represents the natural logarithm of top three executives' payment i in time t;
- OWD_{it} represents the natural logarithm of the number of shareholders for bank i in time t;
- AUC_{it} is presence of audit committee in the board with dummy variable taking 1 if there is audit committee in the board, and 0 otherwise; and
- RMC_{it} is the existence of risk management committee in the board with dummy variable taking 1 if there is risk management in the board, and 0 otherwise.
- α is the intercept of the models;
- β_i represents coefficient of corporate governance and control variables; and
- ε is the error term.

This study uses two control variables, namely:

- (LEVE) leverage (measured by the ratio of total debt to assets); and
- (OWT) ownership type (in Ethiopia there is two types of ownership i.e. state-owned and private bank ownerships and it is measured with dummy variable taking 1 if the bank is a private bank and, 0 otherwise); and besides test results for the Classical Linear Regression Model (CLRM)[1] assumptions were conducted and none of the assumption is violated.

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[1] The first assumption of including constant term, assumption of a constant variance of error terms, the third assumption of uncorrelated error terms, the fourth assumption of normally distributed and the fifth absence of multicollinearity of CLRM are tested.

RESULTS AND DISCUSSION

Descriptive Statistics

The descriptive statistics are based on panel data of the banks from the year 2008 up to 2013.

Table 1 presents key figures, including mean, median, standard deviation, minimum and maximum value.

Table 1: Descriptive Statistics of Regression Variables

Variables	Private (N=48)		State (N=12)		Total sample (N=60)				
	Mean	Std.Dev.	Mean	Std.Dev.	Mean	Std.Dev.	Min	Max	Observations
Proxies of Corporate Governance									
BSZ	9.604	1.455	7.833	1.946	9.267	1.696	6.000	12.000	60
NBM	3.025	0.514	3.091	0.518	3.038	0.511	2.398	4.499	60
PFD	0.036	0.052	0.052	0.054	0.039	0.053	0.000	0.167	60
QUA	0.759	0.279	0.769	0.283	0.761	0.278	0.000	1.111	60
EX	0.089	0.159	0.416	0.442	0.155	0.272	0.000	1.000	60
CEO	11.519	0.366	11.706	0.203	11.519	0.224	10.932	12.018	60
OWD	7.797	0.904	0.000	0.000	6.238	3.247	0.000	9.210	60
AUC	0.792	0.410	1.000	0.000	0.867	0.343	0.000	1.000	60
RMC	0.458	0.504	0.583	0.515	0.483	0.504	0.000	1.000	60
LEVE	0.877	1.000	0.912	0.021	0.884	0.177	0.494	2.126	60
OWT	1.000	0.000	0.000	0.000	0.800	0.403	0.000	1.000	60
Proxies of Bank Performance									
ROE	0.202	0.093	0.336	0.028	0.229	0.115	-0.036	0.704	60
ROA	0.026	0.014	0.135	0.005	0.026	0.012	-0.018	0.071	60

The descriptive statistics indicate that, the average value of return on equity and the standard deviation for the Ethiopian private banks is 20.2% and 9.3% respectively. Contrary, the average value of the state owned banks return on equity is 33.6%. It deviates by 2.8% from the mean value. The financial performance of the private banks and state bank on average is 2.6% and 13.5% respectively as measured by return on asset. It shows a standard deviation of 1.4% for private banks and 0.5% for state owned bank from the mean value. By comparing private and state owned banks together the state-owned banks performed better than private banks.

Regarding the explanatory variables, out of the minimum of six and the maximum of twelve, the mean of board size of the firms is 9.267. This suggests that on the average the sampled banks have board membership of about nine directors. However, a standard deviation of 1.696 suggests that while some banks have relative large board sizes, others have relatively small board sizes. In addition, the table notes that on average frequency of board meeting of Ethiopian commercial during the sample period are 3.038. The standard deviation of 0.511, minimum of 2.398 and the maximum of 4.499 suggest that

there is wide dispersion in the frequency of board meeting of the sample commercial banks. The above table also indicates that the mean and standard deviation of female directors in the board of commercial banks are 3.9% and 5.3% respectively. The result suggests that there are small proportion and high dispersion of women in the board during the sample period. In terms of ownership concentration, the sample commercial bank has mean value of 6.238 and standard deviation of 3.247 and it suggests that there is wide dispersion of ownership in the bank as it measured in terms of number of shareholders. This is due to the inclusion of the fully owned state bank to the sample.

Results of Regression Analysis

The multiple regression results of the study are presented in Table 2 and Table 3 for Model 1 and Model 2 respectively. The regression output reveals that the dependent variable is well explained by the explanatory variables in the model with R-square and adjusted R-square of 0.723 and 0.620 respectively. The F- statistic of 7.01 is also significant with P- value of zero; indicating that the null hypothesis, that all the coefficients are jointly zero is rejected and the

models do not suffer from specification bias.

The regression output in Table 2 is run by taking ROA as a dependent variable and other governance and control variables as independent variable.

Table 2: Regression Result for Model 1

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	0.235490	0.157850	1.491859	0.1430
BSZ	0.000107	0.001327	0.080833	0.9359
NBM	0.005303	0.002923	1.814042	0.0767*
PFD	0.015054	0.025252	0.596164	0.5542
QUA	0.014764	0.006057	2.437469	0.0190**
EX	0.026262	0.008352	3.144321	0.0030***
CEO	-0.022360	0.013606	-1.643452	0.1076
OWD	-0.010648	0.003046	-3.495271	0.0011***
AUC	-0.000580	0.004644	-0.124837	0.9012
RMC	0.013575	0.003561	3.811867	0.0004***
LEVE	0.031762	0.007597	4.180906	0.0001***
OWT	0.087823	0.021731	4.041334	0.0002***

R-squared	0.723103			
Adjusted R-squared	0.620072			
S.E. of regression	0.007562			
F-statistic	7.018281	Durbin-Watson stat	1.144319	
Prob(F-statistic)	0.000000			

***, **, and * denote significance at 1%, 5%, and 10% levels respectively.

The signs of the parameter coefficients indicate that there is positive relationship between frequency of board meeting (NBM), directors who have prior experience in banking (EX), existence of risk management committee (RMC), bank leverage (LEVE), and ownership type (OWT) and bank performance. This reveals that there are a direct relationship between the above five independent variables and ROA. The above table also reveals that there is negative association between qualified directors (QUA) and ownership dispersion (OWD) and bank performance that indicates that there was an inverse relationship between the aforementioned two independent variables and ROA. Thus the increase of those variables will lead to a decrease in ROA.

The regression result of Table 3 points out that risk management committee (RMC) and frequency of board meeting (NBM) is statistically significant at 10% and 5% respectively. Directors who have prior experience in banking (EX), ownership dispersion (OWD), and ownership type are still significant at 1% consistent to the model 1. However, in this model chief executive officer compensation (CEO) is statistically significant at 1% whereas bank leverage is statistically insignificant which is not consistent with the above model. The coefficient signs indicate that the relationship of BSZ and NBM with ROA are now changed in to negative: CEO and AUC with ROA are now changed in to positive.

The regression results of the second model where we have ROE as a dependent variable has presented as follows.

Table 3: Regression Result for Model 2

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-1.543493	0.527275	-2.927302	0.0052***
BSZ	-0.002015	0.009197	-0.219121	0.8275
NBM	-0.049604	0.020914	-2.371837	0.0218**
PFD	0.275927	0.178927	1.542123	0.1296
QUA	0.111234	0.041419	2.685571	0.0099***
EX	0.228783	0.060044	3.810231	0.0004***
CEO	0.169785	0.046944	3.616787	0.0007***
OWD	-0.088271	0.019406	-4.548606	0.0000***
AUC	0.004504	0.033297	0.135258	0.8930
RMC	0.050085	0.024965	2.006172	0.0505*
LEVE	0.003330	0.051700	0.064411	0.9489
OWT	0.680082	0.145601	4.670852	0.0000***

R-squared	0.812622			
Adjusted R-squared	0.769681			
S.E. of regression	0.055057			
F-statistic	18.92424	Durbin-Watson stat	1.783215	
Prob(F-statistic)	0.000000			

***, **, and * denote significance at 1%, 5%, and 10% levels respectively.

Discussion of the Findings

The regression result of Table 2 shows that frequency of board meetings has significant positive relationship with financial performance of banks. This result indicates that regular meetings allow directors more time to confer, set strategy, and to appraise managerial performance. This can help directors to remain informed and knowledgeable about important developments within the bank, and thereby place them in a better position to timely address emerging critical problems. Similar views are shared by Ntim and Osei (2011). However, the regression result of Table 3 reveals that frequency of board meetings has significant negative relationship with financial performance of banks. The finding in this case argues that normally the limited time directors spend together is not used for the meaningful exchange of ideas among themselves. This finding is consistent with (Vafeas, 1999).

Qualification of directors has significant positive relationship with financial performance of banks both in terms of ROA and ROE. This result indicates that the existence of qualified directors increases banks performance as they promote corporate image, and demonstrate accountability and credibility within the management team. The regression result of Model 1 and Model 2 reveal that coefficient parameter of board directors with prior experience in banking significant at 1% significance level suggesting that it has positive relationship with financial performance of banks. The results reveal that senior directors gain more experience and obtain adequate knowledge in banking industry, and thus are more effective in managing the firm. This is in tune with the study by (Poon et al., 2013).

The regression result of Model 2 reveals a positive *CEO pay* coefficient of 0.1697 between the variable and ROE which is significant at 1% which entails that the more compensation is made for CEO, the higher the financial performance of banks in Ethiopia. This also confirms that CEO's compensation does have significant and positive impact upon bank performance as measured in terms of ROE. Thus, the positive and significant coefficient of CEO shows that there is a point at which adding a compensation for CEO increases bank value. The result of Model 1 and Model 2 above also reveal that at 1% level of significance, ownership concentration has a negative coefficient parameter of -0.0106 and -0.0882 with return on asset and return on equity respectively. The negative effect shows the fact that the bank will benefit less from smaller dispersion in ownership.

Furthermore, the regression result of Table 2

and Table 3 indicate that RMC has positive relationship with the financial performance of banks as measured by ROA and ROE. This entails that banks that have a risk management committee in the board did better during the period under review. Therefore, the result contends that risk management committee is the important in corporate governance mechanisms of the bank because it protects shareholders' interests by monitoring management, including the provision of incentive payments to align the interests of managers with those of shareholders; and this is supported by(Walker, 2009).

The regression results of Table 4.2 reveal that bank leverage (LEVE) has significant positive influence on bank performance measured by return on asset (with p-value of 0.0001). Finally, the effect of ownership type (OWT) on bank performance (ROA and ROE) is positive and statistically significant at 1% with parameter coefficient of 0.0878 and 0.68008 respectively indicating that private banks performed less compared to state owned banks. The result is in line with (Zhang and Yang, 2011).

RECOMMENDATIONS

Based on the finding the study recommends that efforts to improve internal corporate governance should focus on the value of the board members like having experienced and qualified directors and risk management committee in the board, since the variables are positively related to both future operating performance and to the probability of disciplinary management turnover in poorly performing banks. The study also suggests that ownership dispersion is negatively related to performance of commercial banks. Indeed ownership structure should be adjusted to enhance the operational efficiency of the banks. In addition, NBE has to encourage commercial banks to implement corporate governance practices through enacting rules and regulations. Finally, the government should revisit its policy and be concerned about the level of internal corporate governance practices of the commercial banks in the country.

CONCLUSION

In sum, the study investigated the determinants of the financial performance of Ethiopian commercial banks from the perspective of their internal corporate governance practices. On frequency of board meeting on bank performance the study provided mixed results. The study concluded that having qualified senior directors who have qualifications in business related disciplines and directors who have prior experience in banking in the board will lead to higher bank performance. Consistent with theory in literature, the directors' greater knowledge base, creativity and innovation were a competitive advantage to improve bank performance. On executive compensation and risk management committee, the study revealed the fact that there is significant positive relationship between the two variables and bank performance. Ownership concentration is negatively related to performance of commercial banks in Ethiopia. This indicates that banks performance benefits from smaller dispersion in ownership in emerging markets, where agency problems are far more severe and where monitoring by banks is compromised by the legal environment.

RECOGNITION

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