THE REVISION OF CORPORATE GOVERNANCE MECHANISMS AND PERFORMANCE OF ASEAN BANKS

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ABSTRACT: *This study is conducted to analyze the impact of the revision of corporate governance mechanisms on the performance of banks in ASEAN from 2011 until 2015. A total of 52 banks with 260 observations from Malaysia, Indonesia, the Philippine and Thailand classified as emerging markets are selected into this study. Evidently, the majority of the variables under risk governance, board governance, and; disclosure and transparency governance revisions have significant relationships with bank performance measured by Net Interest Margin. It is implying that banks in ASEAN should consider the appointment of foreign CRO who directly reported to CEO, having more directors with qualifications and experience in banking and finance while setting for full independence and expert auditing committee in enhancing performance.*

Keywords: Corporate Governance, Banks, ASEAN

1. INTRODUCTION

Banks as an integral component of the financial system must be able to endure any disturbances to ascertain its survival and subsequently stability of an economy. Anything that occurs in the banking communities would have an impact on the national economy and also shapes businesses and individuals in every community throughout the country [1]. Hence, economic prosperity and expansion greatly depend on the services provided by banks whilst its efficiency lowers the capital costs of firms, increase capital formation, and boost productivity growth [2]. It was emphasized that emerging Asia was not totally exempted from the 2007 financial catastrophe although the said countries were less affected as against the more advanced economies [3].

Corporate governance is widely accepted as one of the most prominent elements that bank management must improve continuously to have a more resilient bank. A consultative document by the Basel Committee on Banking Supervision also highlighted that effective corporate governance is critical to the optimal functioning of the banking sector, as well as the economy as a whole [4]. It was also concluded that failures and flaws in corporate governance engagements in the financial industry contributed to the recent global financial catastrophe [5]. However, corporate governance of banks is different from non-financial firms given that banks have many stakeholders as against non-financial corporations [6]. Moreover, the business operations of banks are opaque and complex. Therefore, more enhancing features of corporate governance need to be implemented in the banking sector.

Motivating from that, this study is conducted to analyze the impact of corporate governance mechanisms revisions on the performance of banks in ASEAN from 2011 until 2015 of the post-2007 global financial crisis.

2. LITERATURE REVIEW

Risk Governance

Size of Risk Committee

It was discovered that banks with larger risk committees achieved better profitability but in contrast, the size of the risk committee was negatively associated with market valuation and the expected market growth of banks [7]. Additionally, the more effective control mechanisms can be attained via a larger risk committee since the larger committee normally encompasses members with diverse expertise for effective oversight [8]. This can also result in rising observance over board decisions as well as actions and accordingly, heads towards intensified banks' profitability. Premised on the above and since this governance mechanism was also proposed by Basel Committee on Banking Supervision (BCBS) in their 2010 guidelines under Key Area C-Risk Management and Internal Controls, Principle 7 [9], the following hypothesis is developed: *H1a: There is a significant positive relationship between the size of the risk committee and bank performance.*

CRO Gender

It was discovered that the presence of women board and executives decreased bank risk during the financial crisis [10]. The finding is consistent with the evidence that studies about women board in Zimbabwe, Italy, and Kenya which discovered that board gender diversity improved the financial performance of banks under review [11, 12, 13]. Therefore, the following hypothesis is developed: *H1b: There is a significant positive relationship between female CRO and bank performance.*

CRO Nationality

Foreign directors are expected to improve the advisory role of boards of banks due to their direct information about international markets together with their diverse backgrounds [14]. It was disclosed that board globalization and diversity, including foreign directors; significantly enhanced bank performance [15, 16]. Hence, the following hypothesis is developed: *H1c: There is a significant positive relationship between foreign CRO and bank performance.*

Reporting Line of CRO

Past studies discovered that banks in which the CRO reports directly to the board of directors performed significantly better during the credit crisis than other banks in which CRO did not report directly to their boards (17). This signifies that risk governance in general together with the line of reporting of the CRO specifically were vital to the banks' crisis performance. These empirical results were consistent with much earlier theoretical perspective that emphasized the importance of an effective reporting line from CRO to the Board [18, 19] Considering the above and given that this governance mechanism was also proposed by Basel Committee on Banking Supervision in their guidelines under Key Area C-Risk Management and Internal Controls, Principle 6 [9], the following hypothesis is developed: *H1d:*

There is a significant positive relationship between reporting line of CRO and bank performance.

2.2 Board Governance

Qualification and Experience of Directors in Banking and/ or Finance

The level of financial expertise among directors is positively correlated to risk-taking, both before and during the financial disaster in spite of being consistent with shareholders' value maximization objectives [20]. It was evidenced that amidst the financial disaster, high scores of corporate governance including the general education and background of banks' directors intensify banks' profitability significantly, suggesting that good governance may have moderated the severe effects of the financial tragedy on the financial performance of banks [21]. It is also noteworthy that these corporate governance mechanisms were already recommended by BCBS in their guidelines under Key Area A-Board Practices, Principle 2 [9]. Accordingly, it is hypothesized that i. *H2a: There is a significant positive relationship between directors' qualifications in banking/finance and bank performance. ii. H2b: There is a significant positive relationship between directors' experience in banking/finance and bank performance.*

Board Independence

Findings suggest that companies with a higher fraction of outsider/independent directors usually have a higher valuation [22]. These findings are in line with the evidence that independent directors are more specialized to monitor the board than the executive directors in running successful firms. This objective can be achieved by reducing the concentrated power of the chief executive, whereby it supports the firms to prevent misuse of resources and simultaneously, enhancing performance. Moreover, a higher proportion of independent directors also helped in preventing expropriation through related party transactions [23]. Apart from the above, it is also notable that this governance mechanism had also been suggested by BCBS guidelines under Key Area A-Board Practices, Principle 3 [9]. Therefore, the following hypothesis is developed: *H2c: There is a significant positive relationship between independent directors' majority and bank performance.*

2.3 Disclosure and Transparency Governance

Audit Committee of Full Independence

The Independent audit committee performs better than less independent committees as the more independent team is anticipated to provide more monitoring due to its ability to resist pressure from the management [24]. Additionally, it was testified that a completely independent audit committee as well as an audit committee with a majority of independent members is associated with improved comprehensive details of a firm's accounting earnings [25]. It is also noteworthy that this governance mechanism was also highlighted by BCBS guidelines under Key Area F-Disclosure and Transparency, Principle 14 [9]. In tandem with the aforementioned empirical results, the following hypothesis is developed: *H3a: There is a significant positive relationship between full independent audit committee and bank performance.*

Expert-Independent Audit Committee

The quality of the information in disclosure depends on the standard and practices under which it is prepared and presented. Apart from external auditors, the key parties involved in the said preparation is audit committee members [26]. It was also highlighted that the expertise of an audit committee contributes significantly to quality disclosures [27]. Therefore, rather than only analyzing the relationship between typical disclosure details and bank performance, alternatively, this study concentrates on the caretakers of disclosure and feeders of disclosure details to the external auditors i.e. the audit committee. It was documented that audit committee members with more expertise and managerial experience indeed enhanced firm performance. They opined that these types of audit committees had more exposure to strategic operations of their other firms i.e. more corporate experience [28, 29]. It is also important to note that this governance mechanism was highlighted by BCBS guidelines under Key Area F-Disclosure and Transparency, Principle 14 [9]. Premised on the above, the following hypothesis is developed: *H3b: There is a significant positive relationship between the expert-independent audit committee and bank performance.*

Bank Restructuring

Evidently, bank restructuring has been more prevalent after certain financial turmoil, but it is not the only obligatory pre-requisite for banks to restructure [30]. Banks might also restructure in line with their new corporate strategies or in tandem with fast-changing banking industries' conditions in certain economies. Amongst the common bank restructuring strategies that encompass changes in the banking industry structures are reduction in the number of banks through intensified mergers and acquisition and through bank closures, additional capital injection by the government (nationalization) as well as deregulation for more entry of foreign players. It was emphasized that the performance of banks in Asia emerging economies post-2007 crisis management i.e. after relevant bank restructuring has rarely been investigated. Although there are several cross-country studies on the effects of such factors namely bank restructuring, deregulation, consolidation, and privatization on bank performance, these were largely conducted for the U.S. and European economies [4]. Strong empirical pieces of evidence suggested that foreign bank entry led to a more efficient and more competitive banking industry in China [31]. An empirical finding also demonstrated that the acquirers were comparatively more efficient compared to the targets in six out of the seven merger activities analyzed in the study [32]. Premised on the above, the following hypothesis is developed: *H4: There is a significant positive relationship between bank restructuring and bank performance.*

3. RESEARCH METHODOLOGY

The population for this study is derived from selected listed banks from ASEAN classified as emerging Asia countries. A number of four countries are selected including Malaysia, Indonesia, Philippine, and Thailand. A total of 52 listed banks with 260 observations are chosen for data collection. Since this study intends to evaluate the impact of corporate governance post-2007 financial calamity, data collection encompasses 2011 until 2015.

This study selects the time phase in order to examine the effectiveness of Basel II implementation with proposed continuous gradual reforms via Basel 2.5 and Basel III reflecting on the global financial disaster from 2011 onwards. Data for bank performance and corporate governance mechanisms are taken from the banks' respective annual reports. In addition, the BANKSCOPE database and the related central banks' websites are the sources of data for the control variables. The compositions and definitions of measurements for all variables are explained in Table 1.

Table 1: Definition and Measurements of Variables

Variables	Measurements
Net Interest Margin	Interest Income-Interest Expense) / Interest-Earning Assets
Risk Governance	
Size of Risk Committee (SRC)	Total number of directors on(SRC) the risk committee
CRO Gender (CROGEND)	A binary variable at the value of one if a bank appointed a female CRO. A zero value given if a bank appointed a male CRO.
CRO Nationality(CRONAT)	A binary variable at the value of one if a bank appointed a foreign CRO, zero otherwise.
Reporting Line of CRO(REPORTCRO)	A binary variable at the value of one if the CRO directly to the board, zero otherwise.
Board Governance	
Qualification of Directors (BDQUABKGFIN)	Number of directors who had in qualifications in banking Banking/Finance divided by the total number of directors.
Board Independence Majority (BDINDEP)	A binary variable at the value of one if a bank had a majority number of independent directors on board, zero otherwise.
Disclosure and Transparency Governance	
Audit Committee Full Independence (AUDITFULLIND)	A binary variable at a value of one if a bank's audit committee comprised 100% independent directors, zero otherwise
Expert-Independent Audit Committee (EXPERTINDAC)	Number of directors who also hold other top executive management position (at least General Manager or Senior Vice President and above) in other public listed firms divided by the total number of directors
Bank Restructuring (BKRESTRUCT)	A binary variable at the value of one if a bank had undergone either of these restructuring methods; i) Capital injection by government, ii) Additional off-market foreign equity participation and iii) M&As. A zero value given if a bank did not involve in any one of the said restructuring methods
Total Assets (ASSET)	Log of Total Assets
Consumer Price Index (CPI)	Inflation proxy derived as a percentage of annual change during the selected period
Volume of Bond and Sukuk (BONDSUK)	Total volume for new issuance of bond and Sukuk during a particular year
Money Supply (MONEY)	Annual percentage changes of the national money supply
Stock Exchange Index (STOCKEXCHG)	Annual changes of stock market returns (in percentage)

The model in this study is constructed to test the impact of corporate governance mechanisms revisions on bank performance measured by its net interest margin. The model is specified as follow:

$$Y_{it} = \beta_0 + \beta_1 SRC_{it} + \beta_2 CROGEND_{it} + \beta_3 CRONAT_{it} + \beta_4 REPORTCRO_{it} + \beta_5 BDQUABKGFIN_{it} + \beta_6 BDEXPBKGFIN_{it} + \beta_7 BDINDEP_{it} + \beta_8 AUDITFULLIND_{it} + \beta_9 EXPERTINDAC_{it} + \beta_{10} BKRESTRUCT_{it} + \beta_{11} ASSET_{it} + \beta_{12} CPI_{it} + \beta_{13} BONDSUK_{it} + \beta_{14} MONEY_{it} + \beta_{15} STOCKEXCHG_{it} + \varepsilon_{it}$$

The analysis is conducted on the premise of a balanced panel due to constant and repeated number of years for all the cross-sectional data. Using this method has advantages in dealing with the heterogeneity of variables with less collinearity, reduced bias, and a better degree of freedom. It was argued that longitudinal or pooled data analysis is effective in studying change [33]

4. RESULTS AND DISCUSSIONS

Table 2 demonstrates the outcome of exploring the relationship between full sample governance model governance covering risk governance, board governance, disclosure and transparency governance, bank restructuring together with control variables and bank performance.

Table 2: Panel Regression Results

Variables	Expected	Coefficient	Probability
Corporate Governance			
SRC	+	0.0003	0.4959
CROGEND	+	0.1367	0.2511
CRONAT	+	1.0327	0.0000***
REPORTCRO	+	0.3249	0.0437**
BDQUABKGFI	+	0.0034	0.07275*
BDEXPBKGFIN	+	0.0185	0.0000***
BDINDEP	+	0.1452	0.1746
AUDITFULLIN	+	1.2438	0.0000***
EXPERTINDAC	+	-0.0081	0.0000***
BKRESTRUCT	+	0.2662	0.2571
Control Variables			
ASSET		0.2015	0.0000***
CPI		0.1759	0.0761*
BONDSUK		-1.2733	0.0000***
MONEYS		0.9392	0.2937
STOCKEXCHG		-0.0201	0.0574*
R-Squared		0.3570	
F-Statistic		7.014229	
Constant		-8.178737	
Observations		260	

The significant relationship between nationality and bank performance signifies that foreign CRO did improve the performance of the banks during the period under review. This indicates that the appointment of foreign CROs in the ASEAN emerging banks contributed to their better bottom lines as against local CROs. The result is consistent with past studies that also discovered the positive influence of foreign board on bank performance [34, 35].

Furthermore, CRO should also report directly to the board of directors in order to enhance bank performance. This outcome is consistent with earlier studies that reported banks in which the CRO reports directly to the board of directors, performed significantly better than other banks, in which CRO did not report directly to their boards [17. 18, 19].

In the aspect of board governance, only board qualification and experience in banking and finance have a significant relationship with NIM but board independence majority is otherwise. The findings of this study signify that the appointment of more directors with both qualification plus experience in banking and finance enhanced the profitability of emerging ASEAN banks. The above findings are in line past study which unveiled that amidst the financial disaster, high scores of corporate governance including the general education and background of banks' directors intensify banks' profitability significantly [21].

In relation to disclosure and transparency governance, both audit committee full independence and expert-independent audit committee are significantly related to NIM but with different effects. Banks in ASEAN emerging economies with full independent audit committees registered better NIM than banks without such type of audit committees. The findings is consistent with a past study which reported that financial institutions with more independent directors on their audit committees registered better performance during the global financial turmoil [25].

Concerning expert-independent audit committee, unexpectedly, the accumulation of that kind of independent committee (who also holds top management position of another publicly traded firm) lessened the financial performance of the sample banks. However, it is notable that the coefficient of the negative impact is very low i.e. 0.85%. This signifies that when the sample banks had more expert-independent audit committees, they registered worse performance during the period under review. However, it is notable that the negative coefficient is very small for the sample banks of this research. Correspondingly, it was also discovered that directors with industry experience decreased the market valuation of firms [27]. It is also indicated that bank restructuring in ASEAN emerging markets did not significantly affect the performance of the said banks. This finding is consistent with earlier studies which also found an insignificant connection between one or more bank restructuring measures and bank performance [36, 37]. The effect after certain bank restructuring measures might not be translated immediately into performance change after their implementations, but may take several years which might be subjective in nature. It was documented that the foreseeable advantages of foreign participation deregulation possibly will take a longer time to be realized by the affected banks [38].

5. CONCLUSIONS

The results of this study are expected to be guiding principles for the stakeholders in verifying selected corporate governance reforms that had mostly affect the banks' performances ahead of the 2007 financial meltdown. Thus, the banks' management can strategize and take necessary actions accordingly, consistent with the reforms of corporate governance in order to improve their financial performance. It is implying that banks in ASEAN should consider the appointment of foreign CRO who directly reported to CEO, having more directors with qualifications and experience in banking and finance while setting full independence and expert auditing committee in enhancing performance.

Acknowledgment

The authors would like to extend their appreciation to the Universiti Sains Malaysia for the Research University Grant entitled "How Effective Corporate Governance Codes Revision Affects Firm Performance?" [Grant No. 1001/PMGT/816307] that makes this study and paper possible.

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