The Effect of Corporate Governance on Firm’s Performance: A Review of Banking Sector of Bangladesh

Nikhil Chandra Shil, Rashidul Islam and Netai Kumar Saha

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Message from East West University Center for Research and Training (EWUCRT)

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ABSTRACT

Corporate Governance (CG) becomes a buzzword due to its serious attractiveness to different stakeholders like academicians, practitioners, policy makers etc. In the wake of the century, corporate management becomes the threat of financial manipulator which raises concern to all. CG enters into the realm of board room as a survivor from unscrupulous attitude of few active agents who always search for loopholes to plug in. Banking sector in Bangladesh is not an exception. Like other developing economies, the banking sector becomes the dominant financial intermediary in the financial system of Bangladesh due to underdeveloped capital markets, limited availability of financial instruments and lack of confidence in financial system. Given the bank’s intermediary role in providing stability to the financial system, Bangladesh as well as many emerging economies has implemented policies to develop and restructure the banking sector. An important feature of these policies was to design guidelines for ‘best practices’ known as, ‘CG of banks’. The unique feature of banking industry which deals with the money of the depositors conveys the inevitability to implement CG in this sector. Bangladesh owns a rich history of code of CG. At regular intervals, such code has been updated. Bangladesh Bank, the central bank of Bangladesh, has also issued a separate code which is applicable to banks in addition to the guidelines issued by Bangladesh Securities and Exchange Commission (BSEC). These guidelines are based on the Agency Theory and follow Anglo American model of CG. However, different theories and models are developed globally to address the particular needs under consideration. This study aims to find out any relationship between CG as practiced by banks with performance. This study uses both primary and secondary sources of data for the analysis and exploits different descriptive and inferential statistical tools for drawing conclusions. It also employs ethnography as a research method. The very purpose of this methodology is to interpret social reality. To bring triangulation, an in-depth interview technique is also employed where ten interviews were taken, coded and encrypted to supplement the outcome of quantitative studies. It is expected that the study will add values through its analysis to current state of knowledge and will also offer some areas for new researchers.
ACKNOWLEDGEMENT

We are very much thankful to the almighty God without whose blessings it was not possible to complete the research project. At the same time, we have received enormous support from lot of people who has extended their support for the cause of research. It is not manageable to mention the name of all of them, however, we believe that it is our moral responsibility to acknowledge someone who has taken lot of trouble and allowed us to take their precious time by responding to our queries multiple times.

We would like to express our sincere gratitude to Bangladesh Bank officials, staff from Securities and Exchange Commissions, different public and private banks to give dedicated time to us. We must address few names here like Prof. Dr. Swapan Kumar Bala (Commissioner, BSEC), Mr. Arif Khan (CEO, IDLC Finance Limited and Ex-commissioner, BSEC), Mr. Md. Abdur Rahman Khan (Deputy Secretary, Ministry of Finance), Mr. Abdul Matin Patwary (CFO, Dhaka Stock Exchange Ltd.) etc. Their knowledge and wisdom helped us a lot to bring out best from the project.

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We are really sorry if we have missed anybody who has supported us which is unintentional. We believe that this research will open new avenues of further research in coming days.
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<td>ACC</td>
<td>Anti-Corruption Commission</td>
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<tr>
<td>ACCA</td>
<td>Association of Certified Chartered Accountants</td>
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<td>ADP</td>
<td>Annual Development Program</td>
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<td>ADR</td>
<td>Advance Deposit Ratio</td>
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<td>APT</td>
<td>Advanced Persistent Threats</td>
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<td>BB</td>
<td>Bangladesh Bank</td>
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<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>BKB</td>
<td>Bangladesh Krishi Bank</td>
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<td>BRPD</td>
<td>Banking Regulation and Policy Department</td>
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<tr>
<td>BSB</td>
<td>Bangladesh Shilpa Bank</td>
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<tr>
<td>BSEC</td>
<td>Bangladesh Securities and Exchange Commission</td>
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<td>CBs</td>
<td>Commercial Banks</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CG</td>
<td>Corporate Governance</td>
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<td>CPD</td>
<td>Centre for Policy Dialogue</td>
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<td>FCBs</td>
<td>Foreign Commercial Banks</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>ICAAP</td>
<td>Internal Capital Adequacy Assessment Process</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IRBD</td>
<td>Independent Review of Bangladesh’s Development</td>
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<td>LC</td>
<td>Letter of Credit</td>
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<td>NCBs</td>
<td>Nationalized Commercial Banks</td>
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<td>NEDs</td>
<td>Non Executive Directors</td>
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<td>NOC</td>
<td>No Objection Certificate</td>
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<td>NPL</td>
<td>Non-Performing Loan</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>PCBs</td>
<td>Private Commercial Banks</td>
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<td>RCBC</td>
<td>Rizal Commercial Banking Corporation</td>
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<td>ROA</td>
<td>Return on Asset</td>
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<td>SBs</td>
<td>Specialized Banks</td>
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<td>SLR</td>
<td>Statutory Liquidity Ratio</td>
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<td>SOCBs</td>
<td>State Owned Commercial Banks</td>
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<td>WB</td>
<td>World Bank</td>
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Chapter 1: Introduction

1.1 Introduction

Corporate Governance (CG) has become a topical issue because of its immense contribution to the economic growth and development of nations. The absence of good CG is a major cause of failure of many well performing companies. Existing literature generally support the position that good CG has a positive impact on organizational performance (OECD, 2009; ACCA, 2008; Gompers et al., 2003; Claessens et al., 2002).

Magdi and Naderch (2002) stated CG as the process which ensures that the business is running well and investors are receiving a fair return. A more encompassing definition of CG is given by OECD in 1999 which states that CG structures specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and spells out the rules and procedures for making decisions on corporate affairs. CG includes the processes through which corporations' objectives are set and pursued in the context of social, regulatory and market environment.

Corporate performance is a significant concept that relates to the way and manner in which financial resources, human and other resources available to an organization are judiciously used to achieve the overall corporate objective of an organization; it keeps the organization in business and creates a greater prospect for future opportunities. Maintaining CG at an acceptable level will surely lead the company towards its ultimate goals. May be this is the reason why CG received an increased attention in recent days. Thus an earnest effort is deployed in this study to find out any proven relationship between adoption statuses of CG and improved organizational performance.

The banking sector has flourished during the last three decades as a result of increased demand of the growing economy. During this period, the banking sector has also undergone several reforms and fallen under the jurisdiction of a number of acts in a bid to improve the efficiency of the sector. Nevertheless, the sector is yet to improve its performance in terms of trust and confidence of people as shocks hit the sector from time to time in a significant way. Among these, the issue of governance in the banking sector has currently been under the spotlight in the context of the Hall Mark scam which has been the biggest financial crime in the history of Bangladesh’s banking sector. Given the contribution of the banking sector in the overall development of the country, such processes of misappropriating public resources can have serious implications for economic growth of the country.
1.2 Objectives of the study

The broad objective of the study is to explore any relationship between CG variables on firms’ performances in the banking sector.

The specific objectives are:

- To identify the effect of the size of board directors on the firms’ performance.
- To identify the effect of board independence on firms’ performance.
- To identify the effect of the skill levels of board and management on firms’ performance.
- To identify the effect of the size of audit committee on firms’ performance.
- To identify the effect of the composition of audit committee on firms’ performance.
- To suggest some measures to be undertaken in an effort to improve CG practices of the banking sector in Bangladesh.

1.3 Meaning of Corporate Governance

The term “CG” has a clear origin from a Greek word, “kyberman” meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as “gubernare” and the French version of “gouverner”. It could also mean the process of decision-making and the process by which decisions may be implemented.

It is difficult to define the concept of CG in a universally acceptable way because definitions vary from country to country. Moreover, countries differ from each other in terms of culture, legal systems and historical developments. This explains why there is a wide range of definitions of the concept of CG.

Shleifer and Vishny (1997) define CG in terms of the ways in which suppliers of finance to a firm assure themselves of a good return to their investment. This definition is shallow in that it emphasizes the suppliers of finance and it does not recognize the relationships between a firm’s stakeholders and managers. Each firm has numerous stakeholders whose different interests must be taken care of. This is why CG has also been referred to as a collective group of people united as one body with the power and authority to direct, control and rule an organization.
According to the Organization for Economic Cooperation and Development (OECD) tenets CG is:

✓ A set of relations between the company management, the managing board, its shareholders and other interest groups within the company;
✓ The structure by which company objectives are set as well as the means for achieving these objectives and monitoring performances;
✓ The stimuli system granted to the management board and administration in order to increase the objectives that are in the company’s and shareholders’ best interest and to facilitate monitoring, thus encouraging companies to use their resources more efficiently.

This definition is the most consistent definition, because it specifically integrates a company’s relations to its internal environment, i.e. the shareholders and employees, as well as the outer environment, such as suppliers, creditors and, last but not least, the interaction between the two environments and management frames: management board, company management.

Thus, CG can be defined as the process of practicing accuracy, accountability, smart stewardship, effective internal control, customary corporate behavior in an organization. Good CG is a key factor to achieve the improved performance of an organization. It is a fundamental element to safeguard the interest of shareholders. For continuous and sustainable growth of an organization, there is no alternative to effective CG.

1.4 An Overview of Corporate Governance in Bangladesh

Similar to corporations in Germany, Japan and East Asia, the corporate control mechanisms in Bangladesh are mostly insider oriented such as ownership structure as the core investors own the significant stakes of shares which is also known as ownership control approach (Xu and Wang, 1999) and, in general, are the board of directors. Due to highly concentrated ownership, lack of takeover regulations, a non-efficient market, and due to huge transaction costs associated with the takeover process, some of the important external control mechanisms such as market for corporate control or takeovers are largely absent from Bangladesh corporate sector (Franks and Mayer, 1990; Sarkar, et al, 1998; Asian Development Bank, 2000). Due to the absence of a liquid capital market and some other dominant control mechanisms such as compensation in the form of stock options, debt covenants (even though banks are the major source of corporate financing), and effects of dividend policy in corporate monitoring are also
absent from the Bangladesh corporate sector (Rashid and Rahman, 2008). However, similar to corporate boards in Anglo-American countries, there are the representations of the outside independent directors in the corporate boards in Bangladesh. Therefore, it can be concluded that the corporate control mechanisms in the Bangladesh context is a hybrid of internal and external control systems.

Unlike the corporate boards in continental Europe such as Germany, Finland, Holland and the Netherlands, traditionally the corporate boards in Bangladesh are a one-tier board or management board. There is no supervisory board and both the executive and the non-executive directors perform duties together in one organizational layer, which is most common in Anglo-Saxon countries such as, the United States, the United Kingdom and Canada, Australia, and New Zealand. The "CG Notification 2012" requires that the office of the Chairperson of the Board and the Chief Executive Officer (CEO) should preferably be filled by two different individuals. It also leads to some incidences of CEO duality in some listed companies, giving enormous powers to the CEOs, which reduces the checks and balances and ultimately the monitoring function of the board. In general the board does not have any committee other than the Audit Committee.

1.5 Corporate Governance in Banking

CG in the banking system has assumed heightened importance and has become an issue of global concern because of enhancing services, deepening of financial intermediation on the part of the banks and enabling proper management of the operations of banks. To ensure this, both the board and management have key roles to play in ensuring the institution of CG (Nworji, Adebayo and David, 2011).

The banking sector serves as the nerve centre or brain of any modern economy, being the repository of people’s wealth and supplier of credits which lubricates the engine of growth of the entire economic system (Stiglitz, Jaramillo-Vallejo and Park, 1993; Nworji, Adebayo and David, 2011; Jimoh & Iyoha, 2012). Banking as a financial sector has been unique and the interests of other stakeholders appear more important to it than in the case of non-banking and non-finance organizations. Banks due to a typical contractual relationship, in their CG model should include the depositors and shareholders (Macey & O’hara, 2003). Further, the involvement of government is discernibly higher in banks due to importance of stability of financial system and the larger interests of the public (Leeladhar, 2004, 1102). Stability of banks as a dominant figure in whole financial systems contributes to good functioning of national economy and promotes economic growth (Hermes, 1994; Levine, 1997; Rajan &

Good CG plays a vital role in underpinning the integrity and efficiency of financial markets (Ghillyer, 2012, 88). The Basel Committee on Banking Supervision (BCBS) placed emphasis on establishing and improving the CG of financial entities, as well as compliance with supervisory standards. According to BCBS (2005), CG for banking organizations is arguably of greater importance than for other companies, given the crucial financial intermediation role of banks in an economy.

From a banking industry perspective, CG involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management (Huq & Bhuiyan, 2011). Board of directors is elected by the shareholders as the ultimate decision-making body of the company which has the responsibility of formulating bank loans (Sumner & Webb, 2005). The governance of banking companies may be different from that of unregulated, nonfinancial companies for several reasons. For one, the number of parties with a stake in an institution’s activity complicates the governance of financial institutions. In addition to investors, depositors and regulators have a direct interest in bank performance. On a more aggregate level, regulators are concerned with the effect governance has on the performance of financial institutions because the health of the overall economy depends upon their performance (Adams & Mehran, 2003, 124). The CG of banks in developing economies is important for several reasons:

- Firstly, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth (King & Levine 1993 cited in Arun & Turner, 2004; Levine 1997 cited in Arun & Turner, 2004).
- As financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of companies.
- As generally accepted means of payment, banks in developing countries are usually the main depository for the economy’s savings.

Many developing economies have recently liberalized their banking systems through privatization and reduction of the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks (Arun &
Turner, 2004; Huq & Bhuiyan, 2011). Liberalization of financial system through privatization, the reduction of the role of regulating agencies, mergers and acquisitions have resulted in private and foreign control at the expense of governments and domestic authorities. These latter have allowed bank managers clearly managerial and decision-making freedom (Berger et. al, 2005).

Financial scandals around the world and the public exposure of some recent non-performing lending status in the banking sector of Bangladesh, behind which proper norm of financial management was not applied, have shaken investors’ faith in the capital markets and the efficacy of existing CG practices in promoting transparency and accountability. This has brought to the fore once again the need for the practice of good CG.

1.6 Banking Sector in Bangladesh

After the independence, banking industry in Bangladesh started its journey with 6 nationalized commercialized banks, 2 State owned specialized banks and 3 foreign banks. In the 1980's banking industry achieved significant expansion with the entrance of private banks. Now, banks in Bangladesh are primarily of two types:

- Scheduled Banks: The banks which get license to operate under Bank Company Act, 1991 (Amended up to 2013) are termed Scheduled Banks.
- Non-Scheduled Banks: The banks which are established for special and definite objective and operate under the acts that are enacted for meeting up those objectives, are termed Non-Scheduled Banks. These banks cannot perform all functions of scheduled banks.

There are 56 scheduled banks in Bangladesh who operate under full control and supervision of Bangladesh Bank which is empowered to do so through Bangladesh Bank Order, 1972 and Bank Company Act, 1991. The Scheduled Banks of Bangladesh is mainly divided into two sectors, such as Specialized Banks (SBs) and Commercial Banks (CBs). The Specialized Banks are those banks that deal with specific sectors or industry of an economy. For instance, Bangladesh Krishi Bank (BKB) only deals with the agricultural sector of the economy; Bangladesh Shilpa Bank (BSB) only deals with the industrial sector of the economy, etc.

On the other hand, Commercial Banks are Scheduled Banks that are operating in the country under the rules and regulations of the Central Bank. Commercial banks in turn can be grouped as Nationalized Commercial Banks (NCBs); Foreign Commercial Banks (FCBs) and Private Commercial Banks (PCBs) with three different segments, such as 1st Generation Private
Commercial Banks, 2nd Generation Private Commercial Banks, and 3rd Generation Private Commercial Banks.

Scheduled Banks are classified into following types:

- **State Owned Commercial Banks (SO CBs):** There are 6 SO CBs which are fully or majorly owned by the Government of Bangladesh.
- **Specialized Banks (SBs):** 2 specialized banks are now operating which were established for specific objectives like agricultural or industrial development. These banks are also fully or majorly owned by the Government of Bangladesh.
- **Private Commercial Banks (PCBs):** There are 39 private commercial banks which are majorly owned by the private entities. PCBs can be categorized into two groups:
  - Conventional PCBs: 31 conventional PCBs are now operating in the industry. They perform the banking functions in conventional fashion, i.e., interest based operations.
  - Islami Shariah based PCBs: There are 8 Islami Shariah based PCBs in Bangladesh and they execute banking activities according to Islami Shariah based principles, i.e., Profit-Loss Sharing (PLS) mode.
- **Foreign Commercial Banks (FCBs):** 9 FCBs are operating in Bangladesh as the branches of the banks which are incorporated abroad.

There are now 4 non-scheduled banks in Bangladesh which are:

- Ansar VDP Unnayan Bank
- Karmashangosthan Bank
- Probashi Kollyan Bank
- Jubilee Bank

The Bangladesh Bank (BB) Order 1972 authorized Bangladesh Bank (BB) to be the central bank of the country. Bangladesh Bank Order 1972 and the Banking Companies Act 1991 mainly guide the commercial banks in Bangladesh. Commercial Banks in Bangladesh are not allowed to do business other than just banking. Normal activities include borrowing, raising or taking up of money, lending or advancing of money with or without security. They are also authorized to issue letters of credit, trade in precious commodities and buying and selling of foreign goods excluding foreign bank notes. They are also authorized to trade in bills of exchange, promissory notes, coupons, drafts, debentures, certificates and other instruments approved by Bangladesh Bank (BB). Banking companies are required to provide safe vaults and are authorized to collect money and securities.
All banks operating in Bangladesh with different paid-up capital and reserves having a minimum of an aggregate value of Tk. 5 million and conducting their affairs to the satisfaction of the Bangladesh Bank have been declared as scheduled banks in terms of section 37(2) of Bangladesh Bank Order 1972. Now in terms of section 13 of Bank Company Act, 1991, the minimum aggregate capital is Tk. 200 million.

Figure 1: Banking Sector in Bangladesh

After liberation, the banks operating in Bangladesh (except those incorporated abroad) were nationalized. These banks were merged and grouped into six commercial banks. Of the total six commercial banks, Pubali Bank Ltd. and Uttara Bank Ltd. have subsequently been transferred to the private sector with effect from January 1985. Both conventional (interest based) and Islamic banks (profit sharing principle) operated under the supervision of Central bank of the country. The name of all the banks listed in country’s two stock exchanges and their year of incorporation are given in Table 1 below:
<table>
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<th>Sl.</th>
<th>Name of the Bank</th>
<th>Date of Incorporation</th>
<th>Generation</th>
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<td>1</td>
<td>Rupali Bank Ltd.</td>
<td>1972</td>
<td>1st</td>
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<td>AB Bank Ltd.</td>
<td>1982</td>
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<td>3</td>
<td>National Bank Ltd.</td>
<td>1983</td>
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<td>4</td>
<td>The City Bank Ltd.</td>
<td>1983</td>
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<td>5</td>
<td>IFIC Bank Ltd.</td>
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<td>UCB Bank Ltd.</td>
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<td>7</td>
<td>Uttara Bank</td>
<td>1983</td>
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<td>8</td>
<td>Islami Bank Bangladesh Ltd</td>
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<td>9</td>
<td>Pubali Bank</td>
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<tr>
<td>15</td>
<td>Dhaka Bank Ltd.</td>
<td>1995</td>
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<td>16</td>
<td>Al-Arafah Islami Bank Ltd.</td>
<td>1995</td>
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<td>17</td>
<td>Social Islami Bank Ltd.</td>
<td>1995</td>
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<td>18</td>
<td>Dutch Bangla Bank Ltd</td>
<td>1996</td>
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<td>19</td>
<td>Mercantile Bank Ltd.</td>
<td>1999</td>
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<td>20</td>
<td>Standard Bank Ltd.</td>
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<td>21</td>
<td>One Bank Ltd.</td>
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<td>22</td>
<td>Mutual Trust Bank Ltd</td>
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<td>23</td>
<td>Premier Bank Ltd.</td>
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<td>24</td>
<td>Bank Asia Ltd.</td>
<td>1999</td>
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<td>25</td>
<td>Trust Bank Ltd.</td>
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<td>26</td>
<td>EXIM Bank Ltd.</td>
<td>1999</td>
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<td>27</td>
<td>First Security Islami Bank Ltd.</td>
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<td>28</td>
<td>Jamuna Bank Ltd.</td>
<td>2001</td>
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<td>29</td>
<td>BRAC Bank Ltd.</td>
<td>2001</td>
<td></td>
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<tr>
<td>30</td>
<td>Shahjalal Islami Bank Limited</td>
<td>2001</td>
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**Table 1:** Listed banks with classification
1.7 Recent Scandals in banking sector of Bangladesh

Recent financial scams and increasing default loan size have brought the banking sector of Bangladesh under criticism. Undoubtedly, the banking industry of Bangladesh is increasing day by day with new banks and their branches. Deposits and credits of these banks are also increasing which have contributed to the economic development of the country. Unfortunately, the health check fails to conceal the problems suffered by the sector from time to time. The current situation of large financial frauds and high non-performing loans (NPL) of banks call for a close scrutiny of this sector and necessitates taking required measures.

1.7.1 Hallmark

Hallmark scam has been described as the ever biggest corruption in banking history of Bangladesh. In May 2012, a report from the Bangladesh Bank revealed that the Ruposhi Bangla Hotel Branch of the state-owned Sonali Bank, illegally distributed Tk 36.48 billion (US$460 million) in loans between 2010 and 2012. The largest share of BDT 26.86 billion (US$340 million) went to the now infamous Hallmark Group. The amount of money was paid against false vouchers, letter of credit, issued by different companies of Hallmark group. About 5,600 documents of Sonali Bank have been recovered from Hallmark headquarters. Finger has been raised to the high profile government leaders behind such scam. Apart from this, Bangladesh Bank (BB) officials, Chairman, Members of Board of Directors of the state run bank, all of whom were appointed by political consideration are allegedly involved in this scam, reported the media. While the focus has understandably been on Hallmark, other companies also participated in the fraudulent activities were:

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hallmark Group</td>
<td>Tk. 26.86 billion</td>
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<tr>
<td>T and Brothers</td>
<td>Tk. 6.10 billion</td>
</tr>
<tr>
<td>Paragon Group</td>
<td>Tk. 1.47 billion</td>
</tr>
<tr>
<td>Nakshi Knit</td>
<td>Tk. 660 million</td>
</tr>
<tr>
<td>DN Sports</td>
<td>Tk. 330 million</td>
</tr>
<tr>
<td>Khanjahan Ali</td>
<td>Tk. 50 million</td>
</tr>
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</table>

It is alleged that the scandal resulted from collusion between officials of Hallmark and Sonali Bank, in particular between Managing Director of Hallmark Group and Manager of Sonali Bank’s Ruposhi Bangla branch. The alleged scam exploited the Letter of Credit (LC) system of financing trade. Hallmark is accused of establishing fictitious companies, such as Anwara Spinning Mills, Max Spinning Mills, and Star Spinning Mills, which were shown as recipients
of the LCs. These companies submitted falsified paperwork reporting deliveries of fabric to Hallmark, which were then paid for by the LCs from Sonali Bank’s Ruposhi Bangla branch. Because the fictitious companies and Hallmark had their accounts at the Ruposhi Bangla branch, on paper it looked like the branch’s assets and liabilities were balanced out.

The Daily Star reported that the Bangladesh Bank and the Anti-Corruption Commission (ACC) are separately investigating the roles of 27 state-owned, private and foreign banks in the Sonali Bank loan scandal. The central bank found half of the loans were based on forged local and foreign export bills. It is now inquiring into the 59 branches of the 27 banks to know whether they were partners in any irregularity that helped the Ruposhi Bangla branch buy fake acceptance bills. According to the anti-graft body, some clients of the 27 banks have banking records with money illegally borrowed from the Ruposhi Bangla branch by Hall-Mark Group and five other companies. The banks include state-owned Sonali, Janata, Agrani, Rupali and BASIC banks.

The other twenty-two banks are Shahjalal Islami Bank, Social Islami Bank, Mercantile Bank, National Credit and Commerce Bank Ltd, United Commercial Bank, One Bank, Al Arafah Islami Bank, Jamuna Bank, IFIC, City Bank, Uttara Bank, Prime Bank, State Bank of India, National Bank of Pakistan, Bank Al Falah, Premier Bank, National Bank Ltd, Mutual Trust Bank, BRAC Bank, Islami Bank, Exim Bank and Southeast bank. A top Sonali Bank official said soon after the Ruposhi Bangla branch lent a huge sum of money to Hall-Mark, it was detected that a number of foreign and local banks had been demanding money from Sonali Bank against acceptance bills.

An issuance of these acceptance letters means the branch confirmed with the 27 banks that its client Hall-Mark and five other companies had received due supplies from the clients of some branches of those banks against letters of credit (LC) opened earlier, sources said. And, the branch would pay the money of the delivered goods to Hall-Mark and others within the next 30 days of issuing the acceptance letters. Usually, business clients of the banks do not wait 30 days for the payment of their delivered goods; they want cash as quickly as possible. So they proposed to their banks to purchase the acceptance letter.
As per the banking provisions, banks give their clients 75 percent of the total amount of acceptance letters, a procedure called purchasing “inland bill” of own clients in exchange of an interest rate. When a bank transfers the payment after 30 days of issuing their acceptance letters, the bank at the receiving end pays the rest 25 percent to their client who earlier had sold out the acceptance letter.

The ACC official, on condition of anonymity, said as the Ruposhi Bangla branch issued many such acceptance letters to some branches of 27 banks, the commission decided to look into the matter. Since May 2012, the branch has already paid $111 million (more than Tk. 800 crore) against foreign bills it had accepted or purchased. But, against the inland bills purchases, the 27 banks have been demanding money, which the branch is yet to pay, the official said. A BB official said the central bank had received complaints from different banks that Sonali Bank was not paying their dues against local export bills. So far, 59 branches of those banks have claimed their dues against the bills.

A BB official said they had already inquired into some of the branches and found the involvement of state-run Janata Bank and Agrani Bank in the scam. Detailed investigation is going on in other branches. In one case, the Janata Bank corporate branch opened two accounts in the name of two companies. For both the accounts, Tanvir Mahmud, managing director of Hall-Mark Group, was the introducer. Funds were transferred to the accounts of these companies, although the branch did not inspect whether the two companies existed. The BB also carried out a special inspection on the activities of the principal branch of Agrani Bank. The corresponding banks, which are making claims to the Ruposhi Bangla branch, have a responsibility to see whether the accounts of fake companies were opened with them, the official added. Officials also believe private banks might have been used as platforms for the swindling.

Another central bank official said irregularities over purchase and acceptance of local and foreign bills took place inside branches, banks and with other banks. And irregularities were behind a number of major scams in the banking sector in the country. The official said the central bank was investigating not only Hall-Mark issues but also wrong doing over purchase and acceptance bills. The ACC, too, has asked for documents on all bill purchases against acceptance letters to examine whether there was any other scam involving any other client of the Ruposhi Bangla branch.
1.7.2 Basic Bank

The state-owned BASIC Bank is suffering from severe shortfall of capital as a result of sanctioning loans aggressively without keeping necessary provisions as required by the rules. The bank had fallen into a provision deficit of Tk. 2.1 billion as on December 31, 2012, to adjust which its capital shortage would stand at around Tk. 1.39 billion, said officials at the Bangladesh Bank.

Similar to Sonali Bank loan scam, the government-run BASIC Bank has also suffered a big swindling of around Tk. 4,500 crore over the past several years in yet another big banking scandal as it became public in recent time. The story is almost the same. In BASIC Bank, its board of directors approved the money in different loan cases to different interest groups or business houses in fictitious loans or business accounts. The Board of Directors acted in complicity with dishonest business houses which produced loan request under different projects or import financing bills and the money was disbursed to parties accordingly.

The board approval was reportedly given to loan seekers ignoring the alert of the bank branch officials and also bypassing the cautions against such loans by the central bank authorities. The fake and fictitious loan cases were also discovered in central bank inspections and the branch offices of the bank also informed the central bank of the complicities in approving the loan by the board of directors. But no follow up action was taken and the loan scams continued to such a huge extent. The swindling was taking place over the past few years. The amount was Tk. 3,500 crore last year and the Anti-Corruption Commission launched an inquiry into the alleged embezzlement of that money.

According to the Bangladesh Bank findings, the BASIC Bank’s profit figures during 2009-2012 were Tk. 648 million, Tk. 660 million, Tk. 976 million and Tk. 740 million. During this period the bank disbursed loans of Tk. 29.36 billion, Tk. 63.41 billion, Tk. 56.88 billion and Tk. 85.95 billion. However, the bank’s profit did not increase with the loan disbursement rate; it rather declined in 2012 by Tk. 235 million or 24.15% compared to the previous year.

Activities of desperate loan disbursement at several branches of the bank, which constituted the majority debt and weak management, were mainly responsible for the current ailing situation of the BASIC Bank, the Bangladesh Bank report said. The central bank is now worried that the large amount of capital shortage could have negative impact on the BASIC Bank. At least 27 bankers, who served the state-run-Basic Bank in different sectors and 56 organizations have been found involved in the Bank’s loan scam according to an audit report.
Finance Minister Abul Maal Abdul Muhith informed the Parliament that an external audit firm appointed by Bangladesh Bank and Basic Bank submitted a report based on an investigation about the scandal. The chairman of the board of directors of the BASIC Bank Abdul Hye Bachchu was also involved in the corruption related to irregular loan sanction, recruitment and promotion, the report said.

1.7.3 State-Owned Banks

The government is in a fix over running the country's state-owned banks. The capital deficit of the banks has increased, default loans have shot up alarmingly and large amounts of loans have been written off. Then again there is the massive misappropriation of funds. The state-owned Sonali Bank faced a massive financial scandal during this period. And businessmen in many cases have chosen Janata, Agrani and Rupali Bank for fund misappropriation. As for BASIC Bank, it has been immersed in scams and scandal throughout this period. A World Bank report prepared at the end of 2013 on Bangladesh's economic condition states that Bangladesh's bank sector turned bad from 2009.

Over past few years, among the state-owned four banks, default loans of Janata Bank have gone up by 85%, Sonali Bank by 65%, Agrani Bank by 40% and Rupali Bank by 17%. The total amount of default loans of these four banks combined is about 19 thousand crore taka. Outside of this, loans of about 15 thousand crore taka of these four banks have been written off. And during the same period, about 11 thousand crore taka has been misappropriated from these four banks and BASIC Bank in the guise of loans. Bangladesh Bank sees an alarming rise in new default loans in the government banks. In an evaluation report of the four state-owned banks, Bangladesh Bank observes that in 2013 alone Sonali Bank's new default loans amounted to 4,266 crore taka, Janata's 3,392 crore taka, Agrani's 2,692 crore taka and Rupali 649 crore taka. In all, fresh default loans of 10 thousand 997 crore have been created in these four banks in just a matter of one year.

Former deputy governor of Bangladesh Bank Ibrahim Khaled says, "Since the government is unable to control these banks, they should just keep Sonali Bank and hand over the rest to the private sector." In recent times the four banks were provided with capital of 4,100 crore taka in cash. This was provided through budget allocation. In other words, after destroying the deposits of the public, the banks were once again given public money. Former advisor of the caretaker government Akbar Ali Khan said based on his own experience that the government had been providing these banks with capital since 1991 but it looked as if there is no end to
this. Akbar Ali Khan, who had been finance secretary for a long stretch of time, said that the problem of the banks was in governance structure. That was where problem needed to be addressed. He categorically advised the government to hand over the banks to the private sector.

1.7.4 Oriental Bank

In 2006, Bangladesh Bank dissolved Oriental's Board of Directors after detecting massive irregularities, "inefficiency and unbridled corruption" in operating the bank and converted it to ICB Islamic Bank. Switzerland-based ICB Financial Group Holdings AG bought majority shares (50.10 percent) of Oriental Bank at about Tk. 350 crore ($51 million). It was renamed as ICB Islamic Bank in 2009. Soon after taking over the charge of the bank, the management started devising out ways to restore confidence, attract depositors and borrowers and to recover huge bad loans, according to the bank officials.

A Dhaka court sentenced seven former officials of Oriental Bank, which was later renamed ICB Islamic Bank, to life term imprisonment for misappropriating Tk. 1.7 crore. According to the case documents, the convicts embezzled Tk. 1 crore by forming a fake company named M/S Modern Builders. The Anti-Corruption Commission filed the case with Motijheel police on December 29, 2006 and submitted the charge sheet against the accused on December 31, 2012. According to the corruption watchdog, approximately Tk. 34 crore was embezzled from the Oriental Bank between 2005 and 2006.

One of the major challenges the bank faces is bad debt, the bank top official asserted. “We are taking joint forces' help to recover the bank's huge bad debts worth about Tk. 1,150 crore to strengthen the bank's capital base for funding,” he said. Current total loan portfolio of the bank stands at Tk. 1,530 crore. Of which, 75-77 percent are bad debts, according to officials. The ICB Islamic Bank later decided to refund cash to 93 percent of the depositors of the erstwhile Oriental Bank. The remaining 7 percent of the depositors were supposed to be paid as per the reconstructed scheme for repayment approved by Bangladesh Bank. BB has extended the deadline for refunding all the affected depositors' fund of Oriental by May 2018.

1.7.5 Credit Card Scam

In developed countries like USA and European countries, credit card scam is very common where scammers use spyware and some other mechanisms to obtain card details and use those details to withdraw money with a duplicate card. Instances of credit card fraud can be found in India and other Asian countries as well. But a credit card scam involving over BDT 10 crore detected at United Commercial Bank (UCB) was the first such instance in the banking sector of Bangladesh. Four top and mid-level officials of UCB were found guilty who stole the money from the bank by using 21 credit cards in between 2007 and May 2012. In almost all cases of debit and credit card fraud, it was found that bank employees were involved in those, either directly or indirectly, and they provided the fraudsters with information about clients.

However, many such cases have gone unreported, as Bangladesh Bank, the regulator of the country's banking industry, has no mechanism to get information on this type of fraudulence. And it is yet to issue any security guidelines in this regard. Such fraudulent activities indicate lack of CG and its improper practices among the banks. Bangladesh Bank instructed all commercial banks to have strong and healthy CG so that such fraudulent activities can strictly be monitored.

The Hallmark loan scandal involving Sonali Bank is not the only one. If proper and thorough investigations and comprehensive audit are conducted in the nationalized banks, one cannot but say, many more Hallmarks will come into light, which may put the entire banking sector in an embarrassing situation and the confidence of the depositors may go shattered. The Hallmark scam has not only thrown the Sonali Bank in a 'black hole', but also ruined the trust and confidence of the people in the entire banking sector. This situation can be improved through ensuring good CG within the overall banking sector in Bangladesh which is the main motivating factor of the study.

This study is a contribution to the ongoing debate on the examination of the relationship that exists between CG mechanisms and firm performance particularly in banking industry. Mixed and tenuous findings have been made from previous studies especially those ones that were conducted in the developed nations, particularly USA, UK, Japan, Germany and France. Very few studies have also been conducted so far on the Bangladeshi banking sector in this regard; hence the study intends to reduce the knowledge gap. This work is empirical in nature and will utilize data of 30 commercial banks involved with banking activities in Bangladesh.
Chapter 2: Theoretical Framework of Corporate Governance

History has revealed that there is a never-ending evolution of theories or models of CG. Companies are trying to instill the sense of governance into their corporate structure. The fundamental theories in CG began with the agency theory, expanded into stewardship theory and stakeholder theory and evolved to transaction cost theory. However, these theories address the cause and effect of variables, such as the configuration of board members, audit committee, independent directors and the role of top management and their social relationships rather than its regulatory frameworks. Hence, it is suggested that a combination of various theories is best to describe an effective and good governance practice rather than theorizing CG based on a single theory.

Rashid (2011) argued that there are various theories that can be used to explain CG conventions and also the issues that arise as a result of these conventions. Various theories have been employed in explaining these governance conventions; these theories include the agency theory, stakeholder theory and stewardship theory. Sanda, Mikaila and Garba (2005) also identified these three theories as the main and most significant theories of CG.

According to Imam and Malik (2007) the CG theoretical framework is the widest control mechanism of corporate factors to support the efficient use of corporate resources. The challenge of CG could help to align the interests of individuals, corporations and society through a fundamental ethical basis and it fulfills the long term strategic goal of the owners. It will certainly not be the same for all organizations, but will take into account the expectations of all the key stakeholders.

So maintaining proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities is also achieved by good practice of CG mechanisms. There are a number of theoretical perspectives which are used in explaining the impact of CG mechanisms on firms’ financial performance.

2.1 Types of Theories

Various theories have been employed in explaining these governance conventions; the most important theories are the agency theory, stewardship theory, stakeholders’ theory, resource dependency theory, transaction cost theory, and principal cost theory. The theories as identified here are discussed below in details.
2.1.1 Agency Theory

The theoretical underpinnings for most of the current framework of CG come from the classic work by Berle & Means (1932) which describes the agency problem in modern firms as one arising from the separation of ownership and control. This has been expressed by the authors’ own statements; “It has often been said that the owner of a horse is responsible, if the horse lives he must feed it; if the horse dies he must bury it. No such responsibility attaches to [the owner of] a share of stock. The owner is practically powerless through his own efforts to affect the underlying property. The spiritual values that formerly went with ownership have been separated from it. The responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control”.

The agency theory is a neoclassical economic theory (Ping & Wing 2011) and is usually the starting point for any debate on the CG. The theory was expounded by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). It is based on the idea of separation of ownership (principal) and management (agent). It states that “in the presence of information asymmetry the agent is likely to pursue interest that may hurt the principal (Sanda, Mikailu & Garba, 2005). In this theory, shareholders who are the owners or principals of the company, hires the agents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents (Clarke, 2004).

The agency theory can be traced way back to Adam Smith (1776) and his explanation of main issues that arises as a result of separation of ownership and control of a business. He was of the opinion that managers of funds cannot be expected to have a very watchful eye like the owners or providers of funds. Also, he opined that oversight and extravagant behavior will always persist in the management of the activities of a firm (Smith, 1776). It is earmarked on the assumptions that: parties who enter into a contract will act to maximize their own interest and that all actors have the freedom to enter into a contract or to contract elsewhere. Furthermore, it is concerned with ensuring that agents act in the best interest of the principals. Thus agency problem as described by Jensen and Meckling (1976) focuses on the consumption of perquisites by managers and other types of empire building (La Porta et al., 2000). Jensen and Meckling (1976) established this relationship as an agreement involving at least two parties. The two parties usually involved are the principal and the agent. The principal usually the provider of the fund employs the agent (usually the managers) to perform and run the company on their behalf. Included in the contractual agreement, the principal will bestow upon the agent decision-making authority.
However, the agency problem arises because managers are after their selfish interests and individuals are generally opportunist. The managers (agent) who are put in control of the affairs of the organization may not always consider the best interest of the owners and firm and may pursue their self-activities to the detriment of the welfare of the principals (Sundar amurthy, 1996). As a result of these agency problems, the principal might end up incurring costs known as Agency costs. This Agency cost is a value loss to the shareholders and usually involves the cost of monitoring the activities of managers so that goal congruence can be achieved between shareholders and managers. Jensen and Meckling (1976) suggested that agency costs include the cost of monitoring, bonding costs, and residual loss.

The effect of this agency theory is that one can only try to mitigate against this agency problem when the board is composed largely by non-executive directors (independent and dependent) who will be able to control the activities of managers and thereby maximize shareholders’ wealth (Rashid, 2011; Kaymark & Bektas, 2008 and Luan & Tang, 2007). The theory also suggests that the role of the chairman and the role of the CEO should not be occupied by the same person as this can limit the monitory role bestowed on the board of directors and can also have a negative impact on the performance of the firm. It was suggested that the reason for limit in the monitory role by the board will be loss of board independence as a result of CEO duality (Elsayed, 2007 and Kang & Zardkoohi, 2005). This theory is based on the belief that there is a basic conflict of interest between the owners and managers of the company (Kiel & Nicholson, 2003). This implies that the actions of directors, acting as agents of shareholders, must be checked to ensure that they are in the best interests of the shareholders.

‘The directors of such [joint-stock] companies, however, being the managers rather of other people’s money than of their own, cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company’ (Adam Smith, quoted by Jensen and Meckling, 1976).

2.1.2 Stewardship theory

The stewardship theory has its roots in psychology and sociology and is defined by Davis, Schoorman and Donaldson (1997) as “a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward’s utility functions are
maximized”. The theory adopts a different approach from the agency theory. It stresses not the perspective of individualism (Donaldson & Davis, 1991), but rather the role of top management being as stewards, integrating their goals as part of the organization.

The theory is based on the assumption that the interest of shareholders and the interest of management are aligned; therefore, management is motivated to take decisions that would maximize performance and the total value of the company. The theory believes that there is greater utility in cooperative than individualistic behavior and hence whilst the actions of management would be maximizing shareholder wealth, it would at the same time be meeting their personal needs. The managers protect and maximize shareholders’ wealth through firm performance, because by so doing, their utility functions are maximized (Davis et al., 1997). To achieve this goal congruence, the shareholders must put in place appropriate empowering governance structures and mechanisms, information and authority to facilitate the autonomy of management to take decisions that would maximize their utility as they achieve organizational rather than self-serving objectives. For CEOs who are stewards, their pro-organizational actions are best facilitated when the CG structures give them high authority and discretion (Donaldson and Davis, 1991). Davis et al., (1997) identified five components of the management philosophy of stewardship as trust, open communication, empowerment, long-term orientation and performance enhancement.

Stewardship theory is a contrast or a direct opposite to the agency theory and this theory adopts a more idealistic view of humans. This theory is based on a model and beliefs of the agent not being a self-opportunist but a steward that perceives greater utility in the interest of the principal and the organization as a whole. The theory assumes that a significant correlation exist between the firm’s success and the manager’s satisfaction. This trade-off is achieved by the steward admitting that working towards achieving company’s and collective goals will lead to self-actualization. The theory argues for the post of Chief Executive Officer and Chairman to be held by the same person. Therefore, control lowers the motivation of steward and weakens motivational attitude (Davis et al., 1997).

Stewardship theory poses that stewards are likely to ignore selfish interests in order to pursue the best interest of the firm. Donaldson and Davis (1991) observed that when a steward has been in a company for so long, the steward and the firm becomes one entity. Instead of using the firm for their own selfish interest, the stewards seems to be more in ensuring the continuous existence and long term success of the firm because they now see the firm as an extension of themselves.
2.1.3 Stakeholders’ Theory
Agency theory holds a contractual view of the relationship between managers and shareholders where the managers have the sole objective of maximizing the wealth of shareholders. Stakeholder theory considers this view to be too narrow since manager’s actions have effect on other interested parties than just shareholders. The theory was developed by Freeman (1984) with emphasis on the need for managers to have corporate accountability to stakeholders instead of shareholders.

Stakeholders are “any group or individual that can affect or is affected by the achievement of the corporation’s objectives” (Freeman, 1984). Donaldson and Preston (1995) defined stakeholders as identifiable groups or persons who have legitimate interest in an organization and these interests have intrinsic value. The theory is interested in how managerial decision-making affects all the stakeholders and no one interest should be able to dominate the others (Donaldson and Preston, 1995). Stakeholder theory like the resource dependency theory, also proposed for the representation of the various interest groups on the organization’s board in order to ensure consensus building and to avoid conflicts. The board therefore serves as arbitration over the conflicting interests of the stakeholders and brings about cohesion needed for the achievement of the organizational objectives (Donaldson and Preston, 1995).

The stakeholders’ theory was adopted to fill the observed gap created by omission found in the agency theory which identifies shareholders as the only interest group of a corporate entity. Within the framework of the stakeholders’ theory the problem of agency has been widened to include multiple principals (Sand, Garba & Mikailu 2011). The stakeholders’ theory attempts to address the questions of which group of stakeholders deserve the attention of management. The stakeholders’ theory proposes that companies have a social responsibility that requires them to consider the interest of all parties affected by their actions. The original proponent of the stakeholders’ theory suggested a re-structuring of the theoretical perspectives that extends beyond the owner-manager-employee position and recognises the numerous interest groups. Freeman, Wicks & Parmar (2004), suggested that: “If organizations want to be effective, they will pay attention to all and only those relationships that can affect or be affected by the achievement of the organization’s purpose”.

In summary, the stakeholder theory suggests that a firm’s board of directors and its CEO, acting as stewards, are more motivated to act in the best interests of the firm rather than for their own selfish interests. This is because, over time, senior executives tend to view a firm as an extension of themselves (Clarke, 2004). Therefore, the stakeholder theory argues that,
compared to shareholders, a firm’s top management cares more about the firm’s long term success (Mallin, 2004). Successful organizations are judged by their ability to add value for all their stakeholders. Some scholars consider the natural environment to be a key stakeholder (Dunphy et al., 2003).

2.1.4 Resource Dependency Theory

The resource dependency theory was developed by Pfeffer (1973) and Pfeffer and Salancik (1978) with the objective of emphasizing the important role played by board of directors in providing access to resources that would enhance the company’s performance and protect it against externalities. Companies require resources in areas of finance, human, technical, information, communication and technology to function properly and to achieve their objectives.

Daily et al. (2003) posit that the accessibility to resources enhances organizational functioning, performance and survival. Hillman et al. (2000) argue that resource dependency theory focuses on the crucial role that the directors play in providing or securing essential resources to the company through their linkages to the external environment. They contend that, directors bring resources to the company in the form of information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Organizations depend on each other for business because they form the largest proportion of the organization’s customer base, meaning the actions of one organization can greatly influence the financial performance of the other either positively or negatively. Therefore, the necessity arises for organizations to establish relationships at board levels. Johnson et al. (1996) agreed that the theory provides focus on the appointment of representatives of independent organizations as a means of gaining accessibility to resources critical to the organizations success.

According to Pfeffer and Salancik (1978) boards provide advice, counsel and know-how, legitimacy and reputation, channel for communicating information with external organizations, and preferential access to commitments or support from important factors outside the firm. The boards perform these functions through social and professional networking (Johannisson and Huse, 2000) and interlocking directorates (Lang and Lockhart, 1990). Abdullah and Valentine (2009) classified directors into four categories of insiders, business experts, support specialists and community influential. Zahra and Pearce (1989) posit that the diverse background of the directors enhance the quality of their advice. The theory favours larger boards (Dalton et al., 1999; Booth and Deli, 1996; Pfeffer, 1973; Provan 1980).
Whilst the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm (Abdullah & Valentine, 2009). According to this theory the primary function of the board of directors is to provide resources to the firm. Directors are viewed as an important resource to the firm. When directors are considered as resource providers, various dimensions of director diversity clearly become important such as gender, experience, qualification and the like.

According to Abdullah and Valentine, directors bring resources to the firm, such as information, skills, business expertise, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Boards of directors provide expertise, skills, information and potential linkage with environment for firms (Ayuso & Argandona, 2007). The resource based approach notes that the board of directors could support the management in areas where in-firm knowledge is limited or lacking. The resource dependence model suggests that the board of directors could be used as a mechanism to form links with the external environment in order to support the management in the achievement of organizational goals (Wang, 2009). The agency theory concentrated on the monitoring and controlling role of board of directors whereas the resource dependency theory focused on the advisory and counseling role of directors in firm management.

2.1.5 Transaction Cost Theory

Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. This theory attempts to view the firm as an organization comprising people with different views and objectives. Transaction cost theory is part of the New Institutional Economics research tradition. This theory has become an increasingly important anchor for the analysis of a wide range of strategic and organizational issues of considerable importance to firms (Williamson, 1996). In particular, the transaction cost theory has been employed in studying firms’ boundaries, vertical integration decisions, the rationale for conducting an acquisition, the networks and other hybrid governance forms.

The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms’ transactions to their interests (Williamson, 1996). The main focus of transaction cost theory is the definition of the determinants of coordination of the transactions through markets or hierarchies. In this sense, the boundaries of the firm should be a function of the governance structure (Williamson, 2005), especially when we consider that this governance
structure would assure the optimal adaptability of the firm to changes in the conditions of supply and demand. One important aspect of transaction cost theory is that it focuses not only on the two extremes of transaction governance (hierarchy vs. market), but also on other hybrid forms and long term contracts. Transaction cost theory argues that there are costs to conduct transactions through the market; these transaction costs can be reduced through mechanisms other than markets (Coase, 1937; Williamson, 1975). Specifically there are costs to “drafting, negotiating, and safeguarding any exchange or transaction” that are “friction” impeding smooth transactions (Williamson, 1985).

Transaction cost theory claims that these transaction costs driving economic organization are as important as production costs, or perhaps even more important. Transaction costs are an important part of the total costs of a firm, because production costs are easier to assess than transaction costs, Transactions costs comprise the ex-ante costs of searching and information, drafting and negotiating an agreement, and costs of safeguarding the agreement. The ex-post costs entail the costs of evaluating the input, measuring the output, and monitoring and enforcement (Williamson, 1985).

2.1.6 Principal Cost Theory

A brilliant new study, Principal Costs: A New Theory for Corporate Law and Governance, by Professors Zohar Goshen and Richard Squire shows that the core assumptions behind the statistical and empirical studies that have been used by academics to justify short-termism and shareholder activism are seriously deficient. The study describes principal costs, the costs that arise when investors, due to incompetence or conflicts of interest, exercise control in a manner that reduces company value (such as preventing a very profitable capital investment in favor of funding a special dividend), as a corollary to agent costs, the costs that arise when managers do the same (such as making an acquisition in order to increase the size of the company for the purpose of justifying higher executive compensation). Principal costs have been largely overlooked by academics, whose focus has been solely on agent costs. The study posits that there is an unavoidable tradeoff between principal costs and agent costs and concludes that the division of control that minimizes the sum of principal costs and agent costs is firm-specific, driven by factors such as industry, business strategy and personal characteristics of the investors and managers. The principal-cost theory refutes the Friedman/Jensen/Fama/Bebchuk belief that, across all firms, governance structures that empower shareholders, such as majority voting and proxy access, increase firm value, while governance structures that grant
management autonomy, such as dual class stock and staggered boards, decrease firm value. This belief ignores the impact of such governance choices on principal costs.

Principal-cost theory, in contrast, explains that the variety among existing governance structures reflects the real-world, firm-specific nature of the principal-cost/agent-cost tradeoff, and accurately predicts that, across the governance spectrum, firms will be found to generate consistent levels of financial returns once firm-specific characteristics are properly taken into account. The Goshen-Squire principal-cost theory promises to be a seminal development in the current efforts to curb short-termism and shareholder activism and restore balanced management-centric governance. It is strong support for The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth, which was approved at the August 2016 meeting of the International Business Council of the World Economic Forum.

2.2 Organizations as Organisms - a new Theoretical Framework for Corporate Governance

In the current complex situation where the boundaries between the shareholders and managers have increasingly got blurred and where both are likely to have short term interests in the organization, there is an opportunity and need to evolve formal structures which are not focused on transitory shareholders and managers and are not aimed at creating short term gains but instead refocusing the energies within the organization on creating great companies that build lasting value. The focus of any robust theoretical basis for CG needs to shift from one that aims to balance between the interests of the various stakeholders to one that focuses on the organization and on creating enduring benefit for the organization. One such framework is based on the concept of viewing the ‘organization as an organism’ which has been developed by de Geus, Arie (1997).

According to de Geus (1997), companies are living organisms that are animated by their histories and the learning, skill and commitment of the people who work in them. This truth is completely ignored by most investors, who are more interested in numbers and physical or financial assets and are driven by short-term gains and assets and value extraction as the primary means of making money. In developing his framework, de Geus has drawn up the work of evolutionary biologists who have proposed a new way to describe what makes an organism a unified whole and have defined an organism as an entity that is made up of different parts that cooperate well, but for an overall common purpose, and do so with minimal conflict (Rice University Press Release, November 9, 2009).
Biologists have described organisms not in terms of the degree of relatedness of their parts, nor even what those parts are but have rather defined an organism based on the degree of unity of those parts towards an overall purpose and the relative absence of conflict between them. Similarly in de Geus’s framework an organization is defined not in terms of its constituents but in terms of its overall purpose which is to ensure its own survival and growth. Conventional wisdom, based on the agency theory, holds that corporations are largely economic entities whose primary purpose is rewarding shareholders. When that premise is challenged, it is usually on moral or political grounds. That is the essence of the “stakeholder” argument: a company owes fealty not just to shareholders, but also to its other constituents, such as employees and to its non-shareholder constituents including its government charter. However, de Geus (1997) starts from a very different premise: he believes that an organization’s first loyalty is not to any individual stakeholder(s), but to itself and its continued existence and growth. He emphasizes the need of organizations to focus on the factors that would ensure its longevity and states that companies that focus single-mindedly on profits don’t learn, and therefore don’t thrive or even survive.

Based on a study of long living organizations, carried out while he was at Royal Dutch Shell, de Geus (1997) identified the following four characteristics that increase the longevity of organizations;

1. Sensitivity to the environment, representing a company’s ability to learn and adapt.
2. Cohesion and identity, which are aspects of a company’s innate ability to build a community and a persona for itself.
3. Tolerance and its corollary, decentralization that are both symptoms of a company’s awareness of ecology and its ability to build constructive relationships with other entities, within and outside itself.
4. Conservative financing as a key component in the attribute that enables an organization to govern its own growth and evolution effectively.

Viewing the ‘organization as an organism’ provides us with the framework that would help in guiding the board members of a company to take the right decisions. For instance, consider a situation where a company’s board of directors has to decide between two alternative proposals, one that has the certainty of a 25 percent gain over a six-month period in its existing business as compared with another proposal that involves a risky merger and projects an uncertain gain of 125 percent over a three-year period. In such a situation, how do the individual directors make their decision?
The incumbent CEO, under the agency theory framework, can be expected to vote for or against the merger, depending on what position and power he'll enjoy in the merged entity versus the possibility of his severance, the size of his severance package and what his next job outside the company might be. The chairman, when the position is occupied by a person different from the CEO, might act in his personal interest or out of a sense of stewardship for the narrow interests of his close friends in senior management. A non-executive, but committed director, may feel obliged to vote in stewardship of the owners he represents on the board, be it the founding family, the venture capital fund or the activist shareholder.

In the above situation, decision by the individual directors on the basis of enhancing shareholder value suffers from the limitation that the different director's do not perceive value in a common, meaningful way and have multiple perspectives. Stakeholder theory would prompt the directors to take a decision in the hope, but not the certainty, that taking action in a socially responsible way will be profitable and on the blind faith that even if the decision isn’t profitable, it is still the morally right thing to do. However the confusion over whether the stakeholder objectives are ends or means would lead to different decisions by the various directors and would not bring a consensus on the desired course of action and the dilemma faced by the board members would remain. Under the CG reforms of the previous decades, the decision of the board would, in all probability, rest in the hands of the independent, non-executive, outside directors. They are now, supposedly, in a majority and control all the key board committees. They are able to monitor performance through their control of the audit process, and command the necessary data through their independent staff. They already possess the requisite strategic knowledge through their formal induction to the board and their deepening knowledge of the business through participation in the board meetings. All that they need to take the right decision is a framework to guide them.

The framework of de Geus (1997) helps to create the basis that would guide the independent board members in making the right choice. Instead of aiming for creating/enhancing shareholder or stakeholder value, they need to only look at improving the strategic value for the organization which should become the guiding force for their decisions. Since creating strategic value in an organization leads to increasing its longevity, all strategic decisions must aim to increase an organization’s strategic value. The concept of strategic value incorporates the aims of all socially responsible investors and the stakeholders as well as the collective aims of all interest groups who are not stakeholders. But above all, it incorporates the objectives required to increase the longevity of the organization. Strategic value, while not easy to determine, asks the directors to take actions on the basis of what's best, in a utilitarian sense,
for the viability and continued well being of the organization and, it follows as a natural
corollary, that any stakeholder objective that is not consistent with growth and longevity of the
organization would not be adding to the strategic value of the organization and therefore would
stand rejected, as a decision criterion, by the board member while taking the decision.

The board members have to assess what constitutes strategic value for the organization. For
instance, it would mean judging sources of value - particularly the intangible ones - that might
be lost in a takeover. If the company itself, using its own resources - its people, its customers
relationships, its supply chain, its research and development - has a pretty good chance of
matching the money on offer from a bidder, then it's better to stay independent as doing it
oneself generates the psychological benefits that are valued in aspects of stewardship theory as
well as creating the options for further value creation through having succeeded by itself. If, on
the other hand, the offer is clearly much better than what the company can manage by itself,
it's better to let someone else manage the business.

The appointment and empowerment of non-executive directors (NEDs), who are charged with
the responsibility of providing impartial advice and experience from elsewhere in the business
world, helps in making an objective assessment of the strategic value of an organization. The
NEDs are persons of excellence chosen from different fields with varied professional
experience. The code of best practices of the Cadbury Committee (2000), the BSEC
notification (2012), or Bangladesh Bank circular (BRPD Circular No. 11, 2013) have defined
the roles of such NEDs including defining their selection process and their roles and
responsibilities. As is increasingly reflected in governance codes around the world, the NEDs
are expected to play a crucial and vital role in bringing about ‘good’ governance in the
organizations on whose boards they sit. Basing decisions on enhancing the strategic value of
the organization involved requires the orientation of the independent, non-executive director to
be on the long term, regardless of what the shareholders might say. For while the shareholders
and managers may, after all, be here today and gone tomorrow, the enterprise will always
remain.

2.3 Models of Corporate Governance

In the U.S. and U.K. corporate governance is concerned with ensuring the firm is run in the
interests of shareholders and its objective is to create wealth for them. Underlying this view of
corporate governance is Adam Smith's notion of the invisible hand of the market that he laid
out in his seminal book ‘The Wealth of Nations’. If firms maximize the wealth of their
shareholders and individuals pursue their own interests then the allocation of resources is
efficient in the sense that nobody can be made better off without making somebody else worse off. In this view of the world the role of the firm in society is precisely to create wealth for shareholders. This fundamental idea is embodied in the legal framework in the U.S. and U.K. In these countries managers have a fiduciary (i.e. very strong) duty to act in the interests of shareholders.

Much of research in economics in the more than two centuries since the publication of ‘The Wealth of Nations’ in 1776 has been concerned with understanding when the invisible hand of the market works and when it does not. The requirements for it to work are strong. These include perfect and complete markets so that there are no transactions costs or other similar frictions. There must be no missing markets or externalities such as those arising from pollution. Everybody must have the same information so that nobody has an unfair advantage over others. Markets must be perfectly competitive. These are strong requirements and are unlikely to hold in most economies. The key question is whether such deviations are sufficient to invalidate the basic insight of the invisible hand of the market. In the U.S. and U.K. it is widely agreed that this is not the case and it is accepted that firms’ objective should be to create wealth for shareholders.

In many other countries there is no such consensus. Japan is perhaps the most extreme example. Instead of focusing on the narrow view that firms should concentrate on creating wealth for their owners, corporate governance has traditionally been concerned with a broader view. One way of articulating this view is that corporate governance is concerned with ensuring that firms are run in such a way that society’s resources are used efficiently by taking into account a range of stakeholders such as employees, suppliers, and customers, in addition to shareholders.

With imperfect markets this broad objective can potentially make everybody better off compared to just focusing on the shareholders’ interests (see Allen and Gale, 2000). For example, if there are externalities such as pollution then maximizing the value of the firm is well known to cause a misallocation of resources. If firms were instead to use the broader view above, they would change their behavior and produce the socially optimal level of pollution. In general, although it may not be possible to obtain efficiency it may be possible to achieve a better allocation of resources with the broad view than with the narrow one (see Allen and Gale, 2000, and Allen, 2005).
In countries such as Japan, Germany and France, it is this broad view that is often stressed. Rather than being concerned only with shareholders, a wider set of stakeholders including employees and customers as well as shareholders are considered. In fact in Germany the legal system is quite explicit that firms do not have a sole duty to pursue the interests of shareholders. This is the system of codetermination. In large corporations employees have an equal number of seats on the supervisory board of the company which is ultimately responsible for the strategic decisions of the company. In Japan, managers do not have a fiduciary responsibility to shareholders. The legal obligation of directors is such that they may be liable for gross negligence in the performance of their duties, including the duty to supervise (Scott, 1998). In practice it is widely accepted that they pursue the interests of a variety of stakeholders (see, for example, Allen and Gale, 2000).

Historically, two main types of relationships within the corporate governance function and between the governance function and the management function have been developed. They are known as Anglo-American and German (Continental European) models. Each of these two (conceptual) models solves somehow differently the problem of socio-economic power allocation, the problem of the efficiency of decision-making, and finally the problem of governance and management function conceptualisation.

The corporate governance function has evolved as an organisational function (which is determined by the individual socio-economic system), which is the source of all authority in the corporation, which develops dynamically in the process of determining objectives, goals, policy and making other important decisions, and which has to preserve and to develop the interests of the owners (Lipovec, 52).

The governance function did not carry out its appropriate role in the developed corporate world in the last 30 years (Mac Avoy & Millstein, 9). The increasing number of individual owners, increasing share of institutional owners, decreasing power of individual investors, growing role of multinational corporations, strategic alliances, networks, virtual organisations and enterprise clusters have contributed to such development. The stories of Enron, World Com, Vivendi, Parmalat and many others vividly show the problem.

Privatised corporations in European transitional countries are confronted with the weaknesses of their governance systems too. The state and ‘para-state’ institutions, private investment funds, and internal owners dominate in many companies, while external investors do not have enough voting power to control the companies (Gregorič et al., 184). The underdeveloped capital markets do not provide a needed inflow of fresh capital into the corporation nor does
their low liquidity level offer an indirect owners’ control over the behaviour of management boards.

Historically, throughout its development, a corporation has had one basic objective, i.e. to carry out business activities with a view toward enhancing corporate profit and shareholders’ gain (Mac Avoy & Millstein, 11). The recent development is of the view that other stakeholders should also participate in governance and that they should make major strategic decisions together with owners and supervise managerial decisions and participate in decisions on profit sharing. The continental European environment accepted, at least partly, such a position sooner than the Anglo-American part of the world. “The stakeholders’ concept” of the corporate governance function is gaining support due to many reasons and contemporary developments.

2.3.1 The Anglo American Model

Two extreme views prevail today regarding the corporate governance system (Kuznetsov & Kuznetsov, 256). The new neo-classical school considers shareholders as the only group that governs a company. The corporate social responsibility school requires looking beyond the classical concept of shareholders’ wealth by suggesting the stakeholders’ approach. Many authors prefer to deal with the so-called outsider (USA, UK) and insider (Germany, Japan, other parts of Continental Europe) systems of corporate governance (Gregorič et al., 186). Dispersed ownership and liquid capital markets as well as strong investors’ legal protection are an important assumption of the outsider corporate governance system. The strong legal protection of creditors, a highly concentrated ownership and relatively illiquid capital markets, as well as favouring the stakeholders’ approach seem to be the basic assumption of the insider system.

Legal regulations can allow or forbid the concentration of voting rights in different countries. It is not allowed everywhere that shareholders concentrate their voting rights without concentrating ownership. For example, Germany and the Netherlands allow it. Banks and other financial companies are not allowed to be shareholders in a number of countries. The Anglo-American system does not allow the legal institutionalisation of the employee right to share ownership or profit in companies (the right to economic democracy) (Zalar, 37). One can find an autonomous corporation surrounded by markets in an Anglo-American environment on one hand, and on the other hand, by business groups as a typical constellation of corporations, mostly
with the financial corporation in the centre, in Continental and Northern Europe (Collin & Ceslajs, 163).

Taking into account all the stated differences, one can better understand the logic and distinctive features of the outsider and insider corporate governance systems that we frequently deal with as the Anglo-American and German governance models (Rozman, 103). These two models can also be seen as a one-tier and a two-tier model.

**Figure 2: Anglo American Model of Corporate Governance**

The Anglo-American corporate governance system is based on:

- The organisation of a large independent corporation
- A board of directors that is quite independent regarding its shareholders and stakeholders
- Corporations situated in environments characterised by strong financial markets and small government intervention
- A competitive culture
- A legal system that discourages ownership by banks and other financial organisations.
2.3.2 The German Model

In a narrow sense “corporate governance deals with the ways in which suppliers of finance to corporations assure themselves return on their investment” (Shleifer and Vishny, 1997, 738). In a broader sense, it is “concerned with the institutions that influence how business corporations allocate resources and returns. Specifically, a system of corporate governance shapes who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed” (O’Sullivan, 2001, 1). In this section, the characteristic features of the German system are identified, which justify the use of the term ‘the German model of corporate governance’. These features, presented graphically in Figure 1, have recently found themselves subject to a growing pressure for change.

![Diagram](image)

**Figure 3:** Concentrated ownership under German Model

The level of ownership concentration in Germany is very high. Gorton and Schmid, 1996 for example, reported that 80% of listed companies had a non-financial owner holding at least 25% of shares. Financial intermediaries deserve special attention as owners of companies. There is a system of proxy voting, under which banks can cast votes on behalf of other shareholders, mainly individuals who deposit their shares with banks (Edwards and Fischer, 1994). In this way banks can obtain a significant degree of control, even over widely held companies (Franks and Mayer, 2001). What is more, the largest banks and insurance firms play a central role as spiders in the web of cross-holdings, involving both financial and non-financial firms (Wenger and Kaserer, 1998; Schneider-Lenné, 1994). The scope of cross-holdings and the significance of banks imply that the role of portfolio investors, such as investment funds and pension funds, has been marginal (Davis and Steil, 2000; Blommenstein and Funke, 1998).
The model consists of two governance bodies: the shareholders’ assembly and the board of directors. Members of the board of directors are insiders and outsiders. The board has two main tasks: 1) controlling the business results and 2) controlling strategic decisions. The German (Continental European) model is based on (Collin & Cesljas, 167):

- Business group systems that dominate in the economy
- Weak financial markets
- A strong government intervention
- A rather co-operative or authoritarian culture
- Close connections between corporations and financial organisations.

**Figure 4:** German Model of Corporate Governance

The model incorporates three governing bodies: 1) the shareholders’ assembly, 2) the supervisory board, and 3) the board of directors. Representatives of employees are also members of the supervisory board. Members of the board of directors cannot be outsiders. The main tasks of the supervisory board are to hire and fire the board of directors and to supervise the company’s business performance. Mainly the law determines the role of the corporate governance function.

The management board in German corporations is not selected directly by shareholders but by the supervisory board, which is also supposed to control and dismiss management (Hopt, 1998). In corporations with at least 2000 employees, half of the seats on the supervisory board is reserved for employees, while in smaller firms this share is one third (Mülbert, 1998). The power of employees, referred to as co-determination, is further extended by the role of work
councils and trade unions. Co-determination fits the aforementioned phenomenon of crossholdings. If two companies own a considerable amount of shares in one another, they shield themselves against hostile takeovers, and distribute a smaller part of their profits to external shareholders, thus increasing the retention of profit (Wenger and Kaserer, 1998).

The stock market plays a minor role in the governance of German companies. The number of listed companies and their market capitalization are small in relation to the size of the economy (Van der Elst, 2000). Few companies have shares with high turnover. In 1999 the top 10 companies accounted for over 50% of the total market turnover (FIBV, 2001).

If large amounts of shares change hands, they do so as a result of trade in blocks of shares among large holders outside the stock exchange, and this trade permits price discrimination against minority holders (Franks and Mayer, 2001; Jenkinson and Ljungqvist, 2001; Köke, 2001). Hostile takeovers have been rare, and there has been none but a voluntary takeover code (Baumann, 1998; Bernhardt, 2000; Walter and Smith, 1997). The weakness of the stock market is further compounded by lax disclosure requirements and auditing standards which serve the needs of tax authorities better than those of shareholders (Fox, 1998; Nobes and Parker, 2000; Schmidt, 1998). Corporate governance in Germany is not unique. Many countries have a two-tier board system (e.g. Austria, Switzerland, Netherlands); many have representatives of employees on supervisory boards (e.g. in Scandinavia); and in many countries (e.g. Japan and Italy) banks are highly involved in the control of the corporate sector (Wymeersch, 1998). Germany, however, has attracted special attention as Europe’s largest economy, its post-war economic success and its position in international trade.

In addition, the German model differs diametrically from corporate governance in the US and the UK. In Anglo-American systems there are no supervisory boards, the power of employees is limited, institutional portfolio investors are powerful, capital markets are strong and takeover activities are common. This is why the German model was called an insider, networked, bank-based or closed system, in contrast to the open, market-based Anglo-American system (Prigge, 1998).

Irrespective of the contribution of the German model of corporate governance to the country’s post-war economic success, there can be little doubt that this system is presently under pressure (Dore, 2000). The logic of this pressure can be explained with the framework of the modern industrial revolution set forth by Jensen (1993). Technological progress, which accelerated in the wake of the oil crises in the 1970s and 1980s, along with the globalization of
economic activities (plus European integration in the case of Germany), has increased productivity and led to over capacity in many global markets. The latter calls for corporate restructuring and/or exit, which are facilitated among other factors by a large and liquid capital market and an open market for corporate control. Neither of them exists as yet in Germany, and certain aspects of the German system of corporate governance seem to have hindered their development.

The pressure on the German model of corporate governance implies also the pressure exerted on the German government. The latter has reacted to it by introducing reforms that affect the features of the inherited system. The reform of supervisory boards, introduced in 1998, enhanced the role of audit, and gave shareholders the power to sue members of supervisory boards (Hopt, 1998). Furthermore, corporations with less than 500 employees that are family owned or incorporated later than August 10, 1994 are exempt from the participation of employees on supervisory boards (Roe, 1998). The abolition of capital gains tax on the sale of shares between corporations is expected to make banks, insurance companies, and non-financial corporations downsize and diversify their holdings, thus leading to the erosion of the web of cross-holdings. Last but not least, the introduction of privately managed, funded pensions should create a new and potentially powerful class of institutional investors, focused solely on the return from their portfolios of shares, thus pushing German corporate governance decisively further towards shareholder capitalism (Clark, Mansfield, Tickell, 2000; König and van der Lende, 2000).

### 2.3.3 The Japanese Model

The adjacent Exhibit contains a typical statement of corporate philosophy for a Japanese firm. It is for Asahi Breweries, a well-known Japanese firm. Very little attention is paid to shareholders. In fact they are not even mentioned until Section 6 and then only briefly.
Exhibit

ASAHI BREWERIES LTD.

Corporate Philosophy of Asahi Breweries Ltd

We at Asahi Breweries, Ltd., through our business activities including alcoholic and nonalcoholic beverages, food and pharmaceuticals, wish to contribute to the health and well-being of people the world over. By thus contributing to society as a whole, the company seeks to attain the trust and confidence of the consumer and develop still further.

1. Consumer Orientation
   Identifying the best interests of consumers, we endeavor to meet their demands by creating products suited for contemporary tastes and lifestyles.

2. Quality First
   Open to consumer opinion of our products, we consistently enhance quality level and extend technological capabilities in order to market the finest products in the industry.

3. Respect for Human Values
   Our Company firmly believes that human beings are the core of the business, and follows the principle of human values through developing human resources and implementing fair personnel management. Each employee is encouraged to fully utilize his or her own potential, and work to realize an open, positive thinking corporate culture.

4. True Partnership Between Labor and Management
   Our Company aims to strengthen harmonious relations between labor and management based on mutual understanding and trust. Both parties work hand in hand for corporate development as well as the welfare of all employees.

5. Cooperation with Business Associates
   We seek to build strong relations with all our business associates and affiliates in a spirit of co-existence and co-prosperity based in mutual trust. At the same time, we are determined to accept and fulfill our responsibilities as the core of the Asahi group of companies.

6. Social Responsibilities
   We at Asahi, through securing and expanding the base of our operations, desire to fulfill our responsibilities to stockholders and the local communities in which we operate. Also in
carrying out business activities, we sincerely observe the moral principles of management based on social standards.


The Japanese company Toyota provides an even stronger illustration of the idea that if companies pursue the interests of all stakeholders then a superior allocation of resources can be achieved. On August 1, 2001 the *Financial Times* reported details of the annual meeting of the International Corporate Governance Network which was held in Tokyo that year.

‘Hiroshi Okuda, chairman of Toyota Motor Corporation and of the Japan Federation of Employers' Associations, told the assembled money managers that it would be irresponsible to run Japanese companies primarily in the interests of shareholders. His manner of doing so left no doubt about the remaining depth of Japanese exceptionalism in corporate governance.

…Mr Okuda made his point by telling guests what Japanese junior high school textbooks say about corporate social responsibility. Under Japanese company law, they explain, shareholders are the owners of the corporation. But if corporations are run exclusively in the interests of shareholders, the business will be driven to pursue short term profit at the expense of employment and spending on research and development.

![Diagram of Japanese Model of Corporate Governance](image-url)

**Figure 5:** Japanese Model of Corporate Governance
To be sustainable, children are told, corporations must nurture relationships with stakeholders such as suppliers, employees and the local community. So whatever the legal position, the textbooks declare, the corporation does not belong to its owners. No matter that all the research shows that stock markets respond favourably to higher research and development spending. Nor that the audience consisted chiefly of long-term investors, such as pension funds. The chasm between Japanese and Anglo-American views on what companies is for and whose interests they serve could not have been clearer. "In Japan's case," said Mr Okuda, "it is not enough to serve shareholders."

The view that Japanese corporations have relatively little responsibility towards their shareholders is confirmed in surveys of managers. This section shows the choices of senior managers at a sample of major corporations in the five countries, Japan, Germany, France, the U.S., and the U.K., between the following two alternatives:

a) A company exists for the interest of all stakeholders (dark bar).

b) Shareholder interest should be given the first priority (light bar).

In Japan the overwhelming response by 97% of those asked was that all stakeholders were important. Only 3% thought shareholders' interests should be put first. Germany and France are more like Japan in that 83% and 78%, respectively, viewed the firm as being for all stakeholders. At the other end of the spectrum, managers in the U.S. and U.K., by majorities of 76% and 71% respectively, stated that shareholders' interests should be given priority.

**Table 2: Whose Company is it?**

<table>
<thead>
<tr>
<th>Country</th>
<th>All Stakeholders</th>
<th>Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>97</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>83</td>
<td>17</td>
</tr>
<tr>
<td>France</td>
<td>78</td>
<td>22</td>
</tr>
<tr>
<td>United States</td>
<td>24</td>
<td>76</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>29</td>
<td>71</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of firms surveyed:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan                     : 68</td>
</tr>
<tr>
<td>United States             : 82</td>
</tr>
<tr>
<td>United Kingdom            : 78</td>
</tr>
<tr>
<td>Germany                   : 100</td>
</tr>
</tbody>
</table>
The same survey also asked the managers what their priorities were with regard to dividends and employee layoffs. The specific alternatives they were asked to choose between were:

(a) Executives should maintain dividend payments, even if they must lay off a number of employees (dark bar).

(b) Executives should maintain stable employment, even if they must reduce dividends (light bar).

The following table and figure shows the results. There is again a sharp difference between Japan, Germany and France and the U.S. and U.K.

**Table 3: Job Security or Dividends?**

<table>
<thead>
<tr>
<th>Country</th>
<th>Job Security</th>
<th>Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>97</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>59</td>
<td>41</td>
</tr>
<tr>
<td>France</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>United States</td>
<td>11</td>
<td>89</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>11</td>
<td>89</td>
</tr>
</tbody>
</table>

**Number of firms surveyed:**

<table>
<thead>
<tr>
<th>Country</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>68</td>
</tr>
<tr>
<td>United States</td>
<td>83</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>75</td>
</tr>
<tr>
<td>Germany</td>
<td>105</td>
</tr>
</tbody>
</table>

From: Institute of Fiscal and Monetary Policy (1996), Chart III-4-6, p. 84.

The evidence on managers' views of the role of the firm is upheld by the way that wages are structured in the different countries. In the U.S. and U.K. wages are based on the nature of the job done. Employees' personal circumstances generally have no effect on their compensation. In Japan and Germany it is common for people to be granted family allowances and special allowances for small children. In France vacation allowances based on family are common. These differences underline the fact that in the U.S. and U.K. the firm is designed to create wealth for shareholders whereas in Japan, Germany and France the firm is a group of people working together for their common benefit.

2.4 Comparative Picture

In the U.S. and U.K. the board of directors is elected by the shareholders. It consists of a mix of outside directors and inside directors who are the top executives in the firm. Once elected, the board of directors specifies the business policies to be pursued by the firm. The role of management is to implement the policies determined by the board. Shareholders have very little say beyond electing directors.

Except in unusual circumstances, such as a proxy fight, the outside directors are nominated by the incumbent management and thus typically owe their allegiance to the CEO. Table 4 shows the total number of directors and for the U.S., U.K. and Japan (in parentheses) the number of outside directors for a typical sample of large firms in each of the countries. The size of boards is roughly the same in the U.S. and the U.K. and is usually around 10-15 people. In the U.S. a majority are typically from outside the firm while in the U.K. a minority is external.
Table 4: Number of Members on Board of Directors

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>U.K.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ford</td>
<td>15 (10)</td>
<td>Glaxo</td>
<td>16 (7)</td>
</tr>
<tr>
<td>IBM</td>
<td>14 (11)</td>
<td>Hanson</td>
<td>19 (8)</td>
</tr>
<tr>
<td>Exxon</td>
<td>12 (9)</td>
<td>Guinness</td>
<td>10 (6)</td>
</tr>
<tr>
<td>Philip Morris</td>
<td>16 (4)</td>
<td>British Airways</td>
<td>10 (6)</td>
</tr>
<tr>
<td>RJR Nabisco</td>
<td>9 (6)</td>
<td>Allied Domecq</td>
<td>12 (4)</td>
</tr>
<tr>
<td>Texaco</td>
<td>13 (11)</td>
<td>Grand Metropolitan</td>
<td>14 (1)</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>14 (12)</td>
<td>BTR</td>
<td>10 (4)</td>
</tr>
<tr>
<td>GAP</td>
<td>11 (8)</td>
<td>Associated British Foods</td>
<td>7 (1)</td>
</tr>
<tr>
<td>Mobil</td>
<td>16 (10)</td>
<td>British Steel</td>
<td>8 (0)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Mitsubishi Electric</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Mitsubishi Motors</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Mitsubishi Heavy Industries</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Nippon Steel</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Mazda</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Nippon Oil</td>
</tr>
</tbody>
</table>

Notes: Figures in parentheses:
U.S.: Outside directors
U.K.: Non-executive (outside) directors
Japan: Outside directors (including cross directorships)

Japan resembles the U.S. in terms of the legal form of corporations because of the heavy influence of the U.S. Occupation Forces on the legal system and the structure of institutions after the Second World War. Some important differences do exist, however. The rights of Japanese shareholders are in theory greater than those of shareholders in the U.S. and U.K. For example, in Japan it is easier for shareholders to directly nominate directors and elect them. Also management remuneration must be decided at general meetings of shareholders.

Despite these differences in shareholders' rights, the structure of Japanese boards of directors is such that shareholders do not in fact have much influence. It can be seen from Table 4 that the size of Japanese boards is much larger than in other countries. There are a handful of outside directors but they have very little influence. The overwhelming majority of directors are from inside the company. Their number is such that they include many people in addition to the most senior members of management.

The nominations of individuals for positions as a director are essentially controlled by the company's CEO. This together with the unwieldy size of the board and its composition means CEOs hold tremendous power. Provided the financial position of a Japanese corporation is sound, it is essentially the CEO and those closest to him who control the company's affairs. The structure of many Japanese companies’ boards has changed in recent years. In response to the forces of globalization a number of firms have reformed their boards to reduce their size and bring them more in line with U.S. and U.K. boards.

European transitional countries were able to choose between the stated two governance models. Central European countries chose mainly a variant of the German model. However, Russian reformers opted for the Anglo-American model of corporate governance (Kuznetsov & Kuznetsov, 250). E.g., the Republic of Macedonia’s Law on Trade Companies introduced a solution that allows both the one-tier and two-tier models (Drakulevski, 1132). The Commercial Code determined the corporate governance model in Poland. Its main characteristics are derived from the German model. The shareholders’ assembly, the supervisory board, and the board of directors are characteristic of the two-tier system. Slovenia and Croatia introduced similar systems.
2.5 Code of Corporate Governance in Bangladesh

Corporate governance in Bangladesh is regulated by the guidelines issued by Bangladesh Securities and Exchange Commission from time to time. For banks, Bangladesh Bank has issued circulars from time to time which specify some extra measures for banks in addition to the notifications issued by BSEC. This section presents a brief outline of such regulatory requirements.

2.5.1 Bangladesh CG Guidelines 2012

On 7 August 2012, the Bangladesh Securities and Exchange Commission (BSEC) released the revised CG Guidelines for Bangladesh. In these guidelines, under board effectiveness, the following revisions were made:

- separation between the roles of CEO and chairman is required;
- at least one-fifth of the independent directors must be present at meetings; and
- the independent director requirements must meet extra criteria including specific qualifications criteria.

In addition, the revisions stated that the firm must not enter into any illegal or fraudulent transactions or any transactions that violate the firm’s code of conduct; independent directors must be nominated by the board of directors and shareholders must approve the nomination at the annual general meeting; the post of independent director should not be vacant for more than 90 days; the code of conduct applies to all members of the board as does annual compliance; and the normal tenure of the independent director is three years which can be extended for only one term. In relation to audit committee (AC) affairs, the following guidelines were revised:

- the chairman of the audit committee shall be an independent director;
- ten (10) specific roles of the audit committee must be identified with professional qualifications needed for all members;
- one independent director is required at meetings to satisfy the audit committee’s quorum; and
- the audit committee’s chairman must be present at the annual general meeting.
In addition, the revised guidelines state that: the company secretary may also act as the audit
commitee secretary and that the audit committee must report any material identification to the
BSEC after the expiry of every six-month period from the date of its first report to the board of
directors or after reporting to the board three times when it must be reported to the BSEC
earlier. In terms of auditor independence, the revised guidelines state that neither any partner
nor any employee of the external auditing firm can hold any shares in the client company
during the audit assignment term.

In relation to governance of a subsidiary firm, the revised guidelines are as follows:

a. The subsidiary firm’s board composition must be the same as the holding firm;
b. the holding firm may appoint one of its independent directors to act as a subsidiary
   firm director; and
c. the board meeting minutes of the subsidiary firm can be presented to the holding firm’s
   board meeting for review.

In addition, the revised guidelines are that: the holding firm’s board meeting minutes may state
that the board has already reviewed the subsidiary firm’s affairs and that the audit committee
of the holding firm may review the subsidiary firm’s financial statements encompassing any
investment made by the subsidiary firm. In relation to additional statements by the board of
directors, the revised guidelines are as follows:

a. the outlook and possible future developments in the respective industry have to be
   specified;
b. product-wise or segment-wise performance has to be specified; and
   
c. various risks faced by the organization and related issues must be mentioned.

In addition, discussion in the additional statements is to include the cost of products sold; net
profit margin and gross profit margin of the firm; the continuity of any extraordinary loss or
gain; remuneration to board members; a statement of all transactions related to any party
encompassing the basis of party transactions; and the application of funds increased from
rights issues, public issues or through other instruments (Biswa, 2012).

2.5.2 Bangladesh Bank Circular

Board of Directors of a bank should be comprised of competent and professionally skilled
persons with a view to formulating policy-guidelines and supervising business activities of the
bank efficiently as well as ensuring good governance in the bank management. The
responsibilities of the board of directors of a bank-company are more important than those of
other companies; because in case of a bank-company it is essential to earn and maintain confidence of the depositors as its business is mainly run with the depositors' money.

In addition to Bangladesh CG Guidelines 2012, the following directives are also given by Bangladesh Bank for ensuring good governance in banking sector regarding constitution of board of directors, their duties & responsibilities and other related activities.

- The newly amended Section 15 of the Bank Company Act, 1991 (Amended up to 2013) includes that a bank can appoint a maximum of 2 (two) members from a family as director.

- Bangladesh Bank can remove a director or chairman of a bank, except state owned banks, for conducting any kind of activities that is detrimental to the interest of the banks depositors or against the public interest under Section 46 and can supersede the board of a banking company under Section 47 of BCA, 1991.

- Subject to compliance of section 101 of the Companies Act, 1994, an alternate director can be appointed to act for a director during his absence for a continuous period of not less than three months from Bangladesh.

- Appointment of Depositor Directors of the Bank Company Act, 1991 has been amended; appointment of director from depositors is no longer required. But, after complying regulation under sec 15(9) of the Bank Company Act, 1991 (amended upto 2013) bank can consider the tenure of existing depositor director or may appoint them as independent director.

- The board shall be vigilant on the internal control system of the bank in order to attain and maintain satisfactory qualitative standard of its loan/investment portfolio. The board will establish such an internal control system so that the internal audit process can be conducted independently from the management. It shall review the reports submitted by its audit committee at quarterly rests regarding compliance of recommendations made in internal and external audit reports and the Bangladesh Bank inspection reports.

- No member of the board of directors shall be included in the selection committees for recruitment and promotion to different levels. Recruitment, promotion, transfer & punishment of the officers immediate two tiers below the CEO shall, however, rest upon the board. Such recruitment and promotion shall have to be carried out complying with the service rules i.e., policies for recruitment and promotion.
✓ The annual budget and the statutory financial statements shall be finalized with the approval of the board. It shall at quarterly rests review/monitor the positions in respect of bank's income, expenditure, liquidity, non-performing asset, capital base and adequacy, maintenance of loan loss provision and steps taken for recovery of defaulted loans including legal measures.

✓ The decision on matters relating to infrastructure development and purchase of land, building, vehicles etc. for the purpose of bank's business shall, however, be adopted with the approval of the board.

✓ The board of directors is to appoint an honest, efficient, experienced and suitable CEO or Managing Director. The Board of directors will appoint a suitable CEO with the approval of the Bangladesh Bank.

✓ Board of directors may meet once or more than once in a month if necessary. But Board of directors shall meet at least once in every three months. Excessive meetings are discouraged.

✓ As the chairman of the board of directors or chairman of any committee formed by the board or any director does not personally possess the jurisdiction to apply policy making or executive authority, he/she shall not participate in or interfere into the administrative or operational and routine affairs of the bank.

✓ Any complaint against the CEO shall have to be apprised to Bangladesh Bank through the board along with the statement of the CEO.

✓ Each bank company can form 1(one) executive committee, 1(one) audit committee and 1(one) risk management committee with the directors. Board can't form any other permanent, temporary or sub-committee except the above mentioned three committees.

✓ Executive committee should be formed with the members of the board to continue the urgent and daily or routine works between the intervals of two board meetings. Executive committee will perform according to their terms of reference determined by the board of directors.

✓ The committee will review the financial reporting process, the system of internal control and management of financial risks, the audit process, and the bank's process for monitoring compliance with laws and regulations and its own code of business conduct.

✓ The audit committee should hold at least 4 meetings in a year and it can sit any time as it may deems fit;
2.6 Qualitative Models

In recent days, different qualitative models are used in the field of corporate governance to bring holistic approach in research. The main purpose of qualitative models is to dig into the depth of research question to uncover the reality in its very organic form which quantitative models fail to discover. Out of different qualitative models, two models are found very active in the field of corporate governance. This section gives a brief presentation on them.

2.6.1 New Institutional Sociology

New Institutional Sociology (NIS) addresses the behavior of organizations as motivated by forces in wider society. It argues that organizations will seek legitimacy by adhering to rules and norms that are valued by society and, more specifically, by certain institutions in society. The mechanism through which organizations adopt similar procedures is termed institutional isomorphism. Isomorphism is ‘a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions’ (DiMaggio & Powell, 1983). Early NIS theorists sought to explain how different organizations, in many respects, conformed to similar standards of behavior and how they employed similar structures. Moreover, they sought to explain the stability in these standards of behavior and organizational structures. DiMaggio & Powell (1983) distinguish three mechanisms of institutional isomorphic change: Coercive isomorphism, Mimetic isomorphism, and Normative isomorphism. These three mechanisms cause organizations to become increasingly alike. Therefore, one can argue that NIS is more a theory that explains similarities amongst organizational structures than change in organizations (Greenwood & Hinings, 1996).

Coercive Isomorphism

Coercive isomorphism relates to the formal and informal pressures that result from coercive authority. This coercive authority comes from the organisation’s dependency on other organisations and the cultural expectations in the society in which the organisation functions (DiMaggio & Powell, 1983). Organisations may alter some of their structural features quite directly as a result of changing legislation (think of stricter anti-pollution laws, employee health and safety codes and consumer laws), but they can also change more organically in response to changing societal preferences. DiMaggio & Powell (1983) and Meyer & Rowan (1991) argue that these organisational re-configurations can be in large part ceremonial, but
that does not mean that they are inconsequential. Rather, they convey the message to the various stakeholders in the organisation that the organisation is responsive to the preferences of the society in which it operates. This adherence to societal preferences helps the organisation to secure economic resources, influence and power.

Mimetic Isomorphism

A second process leading to institutional isomorphism is called Mimetic Isomorphism. DiMaggio & Powell (1983) argue that uncertainty is a powerful incentive for imitation. In particular, ambiguous goals, poorly understood technologies or symbolic uncertainty may cause organisations to model themselves on other organisations. The introduction of Japanese management techniques in US firms constitutes an example of changes caused by mimetic isomorphism. American firms (and so called knowledge entrepreneurs) observed the successes of Japanese manufacturing industries and introduced their understanding of the techniques used by the Japanese firms. In addition, DiMaggio & Powell (1983) argue that one of the reasons that organisational structures tend to be homogenous is that there are not many different organisational models to imitate. Therefore, attempts to select an organisational structure to deal with ambiguity and uncertainty are often based on similar organisational templates. The change from a functional structure to a multidivisional structure is an example.

Normative Isomorphism

The third source of isomorphic organizational change is normative isomorphism. It stems from pressures from professionalisation. DiMaggio & Powell (1983) argue that two aspects of normative isomorphism are of particular interest: (1) the grounding of formal education and of legitimation on a cognitive base produced by university specialists; and (2) the growth and influence of professional networks that allow new practices to be diffused rapidly across organisations. Universities function as knowledge centres that influence the development of professional norms and values for organisations. As such, they promote normative standards that make professionals comparable; i.e. their behaviours can be measured against these normatively determined standards. Examples are professional associations for accountants, medics and lawyers. These professionals have strong ties with their professional bodies, which determine the criteria for ‘proper’ and professional behaviour (cf. Greenwood et al., 2002).
These criteria are strongly influenced by universities and professional training centres. ‘To the extent managers and key staff are drawn from the same universities and filtered on a common set of attributes, they will tend to view problems in a similar fashion, see the same policies, procedures, and structures as normatively sanctioned and legitimated, and approach decisions in much the same way’ (DiMaggio & Powell, 1991, p. 72). Normative Isomorphism related to professional managers focuses our attention on the norms and values embedded in the act of management. Managers operate in a set of roles, a web of relationships with internal and external groups and individuals. They are constrained by their own structure of reality, which is influenced by normative pressures and accepted ideas on ‘proper’ behaviour (e.g. see: Berger & Luckmann, 1979; Pettigrew et al., 1992; Javidan & Dastmalchian, 1993).

2.6.2 Structuration theory of Anthony Giddens

The British social theorist Anthony Giddens has developed a theoretical structure that explains human agency (action) in the context of social structure and integrate action and structure. In this approach, termed structuration theory, Giddens argues that human agency and social structure are not two separate concepts or constructs, but these are together produced by social action and interaction. In sociological analysis, their separation may be a result of how sociologists examine and interpret social reality, with agency and structure being two ways that social action can be studied and understood sociologically. There is a duality of structures in society – on one side there are individuals as actors in particular situations, who enter into knowledgeable activities and participate in social action and interaction in these situations. At the same time, the social world is composed of social systems and structures – these are the rules, resources, and social relationships that actors produce and reproduce through social interaction. The study of structuration means examination and analysis of the ways in which social systems are produced and reproduced in social interaction (Giddens, 1984). Giddens defines structuration as “the structuring of social relations across time and space, in virtue of the duality of structure” (Giddens, 1984).

The structuration theory of Giddens is a sociologic one. The relationship between the individual and society is of central concern to this theory. Social phenomena are neither the product of structure or agency alone, but of both. Objective social structures are defined by properties of society as a whole and autonomous human agents are defined as properties of the individual (Giddens, 1984). Giddens contends that structure and interaction are a mutually
constitutive duality. This duality is somewhat comparable to the reification – participation duality from the Communities of Practice framework of Wenger.

![Diagram](image.png)

**Figure 6:** Giddens’ Duality of Structure (Giddens, 1984)

If we look at the figure above, there are three dimensions of structure, which are signification, domination and legitimation. The three dimensions of interaction are described as communication, power and sanctions. The means by which structures are translated into actions are called modalities, which are interpretive schemes, facilities and norms. These modalities can explain why and how interaction is affected. Without going too much in detail, the first dimension refers to production of meaning (e.g. a person with a white coat in the hospital has the role of a doctor), the second to degrees of power (e.g. a police officers’ uniform enable them to fine somebody who broke the speed limit) and the third to societal norms (e.g. formal clothing during most interviews).

In short, structure is something that can be set, it’s organized at the beginning. According to Giddens, they are allocative and authorative resources, and social and formulated rules. Modality can be seen as the tools, it makes interaction possible, and can be influenced along the way. The result is that social interaction, for example on communities, is influenced by structure and the three modalities interpretive schemes, facilities and norms. The interpretive scheme translates structure into actions.
Chapter 3

Literature Review and Hypothesis Development

CG has no single accepted definition; this is often attributed to the huge differences in countries CG codes (Solomon, 2010). The definition varies based on the framework and cultural situation of the country under consideration (Armstrong and Sweeney, 2002). Also, the differences in definition can be as a result of the different viewpoint from the different perspectives of the policy-makers, researchers, practitioners, or theorists (Solomon, 2010). The term ‘CG’ came into use in the 1980s to broadly describe “the general principles by which businesses and management of companies were directed and controlled” (Dor et al. 2011). O’Donovan (2003, 2) see CG as “an internal system encompassing policies, processes and people which serves the needs of shareholders and other stakeholders by directing and controlling management activities with good business savvy, objectivity and integrity”. In other words it defines the legal, ethical and moral values of a corporation in order to safeguard the interest of its stakeholders.

The aim of CG is to ensure that corporations are managed in the best interests of their owners and shareholders (Ahmed, Alam, Jafar & Zaman 2008). This applies specifically to listed companies where the majority of the shareholders are not in participatory everyday management positions; although, it can also apply to other forms of corporations such as companies with few principal owners and a large group of smaller shareholders, public corporations (where all citizens are stakeholders) partner-owned companies and privately owned companies where the ownership has been divided through inheritance in one or several generations (Ahmed, Alam, Jafar & Zaman 2008).

Another essence of CG is establishing transparency and accountability throughout the organization. This is feasible as CG system is premised on a strict division of power and responsibilities between the shareholders through the annual general meeting, the board of directors, the executive management and the auditors.

Previous studies (Williams, 2000; Rajan and Zingale, 1998; Brickly et al., 1994; Drobetz et al., 2003; Hossain et al., 2000; Byrd and Hickman, 1992; Rosenstein and Wyatt, 1990; Weisbach, 1988; Gemmill and Thomas, 2004) have found positive relationship between good CG practices and firm performances. However, other studies (Hutchinson, 2002; Bathala and Rao, 1995) have found negative relationship. Despite these conflicting results, the literature
generally attests that there is no doubt as to the importance of good CG in enhancing firm performance.

Figure 7: Basic Structure of a CG System

Source: Adapted from Ahmed, Alam, Jafar & Zaman 2008

Researchers, scholars and governments are increasingly playing a greater role in developing and formulating CG practices. The international monetary fund in its debt relief programs insisted governance improvements as a perquisite for their programs (Khanchel, 2007). In the aftermath of the financial crises in 2007, OECD (2009) on the corporate lessons from the financial crises concluded that, the crises was largely due to failures and weaknesses in CG arrangements which could not serve their purpose to safeguard against excessive risk taking by the financial institutions.

The importance of CG arises in a firm because of the separation between those who control and those who own the residual claims (Epps & Cercoia, 2008). Furthermore, agency theory assumes an opportunistic behavior that is individuals want to maximize their own expected interests and are resourceful in doing so (McCullers & Schroelder, 1982). Therefore, there will be a conflict of interest between managers and shareholders. Macus (2008) argues that the basic issue from an agency perspective is how to avoid such opportunistic behavior. Since, shareholders appoint board of directors to apply their investment in firm’s activity, an information asymmetry occurs because management has the competitive advantage of information within the company over that of the owners (Zubaidah 2009). It can provide
management with the opportunity to expropriate firm wealth in their benefit. Hence, agency theory suggests CG as a mechanism to reduce these conflicts by monitoring manager’s performance and aligning management’s goals with those of the stakeholders (Brickley & James).

Abdullah (2004) argues that the opportunistic behavior of management can lead to reduce the value of the firm. Therefore, the board’s success in discharging its fiduciary duties and monitoring roles would be predicted to increase the value of the firm and enhance the shareholders’ wealth. Masood Fooladi (2011) found that CEO duality has a negative relationship with firm performance (Return on Equity and Return on Assets) but there is no significant relationship between board independence, board size, and ownership structure as independent variables and firm performance as depended variable.

Sound governance provides improvement when the company is under-performing due to poor management (Lipton and Lorsch, 1992). Therefore, for the better performance of the banks, CG works as a remedy to overcome managerial inefficiency. According to the CG theories (Levine, 2003; Caprio and Levine, 2002; Macey and O’Hara, 2003) board of directors and its committees are responsible for ensuring some specific responsibilities. Some of them are -

i) Disclosure of accurate, timely and reliable information to shareholders.
ii) Setting key targets of the Bank and monitoring progress towards achievement of such targets.
iii) Approval of major policy decisions and long term strategic plans to achieve key objectives in an efficient and effective way.
iv) Ensuring appointments of right people in key management positions with appropriate compensation package and to evaluate their performance to encourage long term success of the Bank.
v) The Board must be satisfied that sufficient risk management systems are in place to mitigate core risks of the bank and that there are adequate checks and balances in the internal control system to protect the value and quality of assets of the Bank.

3.1 Corporate Governance Scenario in Bangladesh Banking Industry

A number of studies on the CG in Bangladesh banking industry were undertaken. All these studies determined that CG practices in banking industry were poor and that Bangladesh had lagged behind its neighbors and the global economy in CG (Gillibrand, 2004). One of the principal reasons for poor CG is that most of the organizations are family oriented and the Board of Directors is actively involved in management (Haque, Jalil and Naz, 2007). In the
framework of Bangladesh, independent directors do not act as a supporter of majority shareholders or as a source of innovative ideas (Bangladesh Enterprise Institute 2003). But the companies Act 1994 provides for many strict rules regarding any negligence, default, breach of duty or trust on the part of director, manager or officer of a company. But these rules are more honored in the breach than in observance (Ahmed and Yusuf, 2005).

Different Researchers (Afroze and Jahan, 2005; Bhuiyan and Biswas, 2007; Arun and Turner, 2003) supported the need for the broader approach to CG and the inevitability of government intervention for banking institutions of Bangladesh to bring the behavior of bank management under control. Studies have discovered number of reasons for malpractices of CG (CG) in banking sector of Bangladesh. Ahmed and Yusuf (2005) identified one of the principal reasons for poor CG (CG) on running the corporate entity in Bangladesh. They found that most of the listed companies are family oriented and these companies prefer to keep ownership holdings within the family connections. As a result, small group of shareholders own or control the majority of shares and by using that majority control the decision-making processes of the companies.

Ahmed and Baree (2000) summarized the principles and standards of CG as agreed and put forth by Organization for Economic Co-operation and Development (OECD), Cadbury committee (UK) and other international committees. The authors found some problems of implementing international CG norms in Bangladesh and finally make certain recommendations for reforming of CG as well. The article recommends three substantive actions be taken for the improvement of CG scenario in Bangladesh.

- First, a ‘high powered committee’ including members from government, regulatory agencies, companies and ICAB should write a code for CG in Bangladesh.
- Second, amendments to existing laws should be adopted to enforce CG norms.
- Third, academic and professional institutions should include CG principles in their syllabus.

A comprehensive diagnostic study was conducted by Bangladesh Enterprise Institute (2003) as a project, which pursues to focus on them vital areas that have been identified internationally as essential to good CG. Weak regulatory system has also been identified as a barrier in the way of achieving sound CG. The presence of weak regulatory system prevents the current laws and statutes from being applied. Board committees which are very essential for sound CG are composed of Audit Committee, Remuneration Committee and Nomination Committee. The Audit Committee monitors the integrity of financial statements, reviews internal financial controls, recommends appointment of external auditors and reviews auditor independence and
objectivity and audit effectiveness. The Remuneration Committee is accountable for reviewing the remuneration of directors and senior management and advising the Board whether the amounts are reasonable in comparison with industry and corporate yardsticks. The Nomination Committee is liable for proposing new nominees to the Board and advising the Board on the fundamental skills required of new directors (Psaros, J. and Seamer, M. 2002).

Like other developing countries, banks play a vital role in Bangladesh economy, as the dominant finance provider for the industrial and commercial activities. Since the independence in 1971, the government until 1982, when the ‘ownership reform’ measures started in the financial sector, had carried out the regulation and ownership of all the financial institutions. During the reform period, two out of six National Commercial Banks (NCBs) were denationalized and private commercial banks were allowed to operate in the country. Despite the expansion in the present, the operational efficiency of the banking institutions has continued to be dismal (Sayeed, 2002; Raquib, 1999).

The sector observed diminishing profitability, growing non-performing assets, provision and capital shortfalls, eroded credit discipline, rampant corruption patronized by political quarters, low recovery rate, inferior asset quality, managerial weaknesses, excessive interference from government and owners, weak regulatory and supervisory role etc. (Hassan, 1994; USAID, 1995). Internal control system along with accounting and audit qualities are supposed to have been insufficient (World Bank, 1998; Raquib, 1999; CPD, 2001). Many of the difficulties have been recognized to be lack of sound CG among the banks. Banking Reform Commission (1999) and BEI (2003) raise serious concerns on the banking sector and criticize the quality of governance in the banking sector in Bangladesh, which provides an impetus to explore the governance issues in detail. However, there are some additional reasons that are unique to the financial sector which require attention to this issue. These are:

(i) The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems.

(ii) The failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.

(iii) Private sector banks are motivated by profit maximization and their own financial stakes are limited and relatively low and they are therefore prone to excessive risk taking with the depositors’ money.

Given the vital financial mediation role of banks in an economy, their potential difficulties arising from ineffective CG and the necessity to safeguard depositors’ funds, CG for banking
organizations is of great importance to the international financial system. Banking companies draw unique CG attention as they differ greatly with other types of firms in terms of broader extent of claimants on the banks assets and funds. A group of entrepreneurs and/or executives could set up a banking business by putting very little capital from their own pocket as the nature of business itself guarantees flow of huge amount of funds in the form of deposits. The general approach to CG claims in favor of the shareholders rights only, as managers/executives may not always work in the best interest of the shareholders (Henderson, 1986; Jensen and Meckling, 1976; Fama and Jensen, 1983). But the shareholders actually account for a very little portion of the bank’s assets and funds. Rather almost every bit of banks’ investments are financed by the depositors’ funds. In case of losses or failures it will be depositors’ savings that the banks would lose. Such risks demand priority in the protection of depositors that ushers in a broader view of CG that suggests the interest of the suppliers of funds for a firm should be upheld (Shliefer and Vishny, 1997; Vives, 2000; Oman, 2001).

Macey and O’Hara (2001) also claim that CG should be adopted in the case of banking institutions, arguing that because of the peculiar contractual form of banking, CG mechanisms for banks should encapsulate depositors as well as shareholders. Arun and Turner (2003) supported the prerequisite for the broader approach to CG for banking organizations and also argue for government interference to restrain the behavior of bank management. In many countries, deposit insurance is used as a mechanism to safeguard the banking system as well as the depositors. However, Macey and O’Hara (2001) argues that in many cases, the presence of deposit insurance mechanism by the governments may encourage many bank insiders to embark upon self-benefiting risky deals taking the advantage of insurance protection. The self dealing activities by the bank insiders are very risky to the performance and survival of the banks as scores of previous bank failures have been caused by unsafe self-dealing by the bank insiders (Jackson and Symons, 1999; Clarke, 1988).

The presence of heavy liquid assets and lack of depositors’ interest to actively control and monitor banks’ risky decisions as a result of the insurance guarantees simplifies the sharking in the banking firms. Banks in Bangladesh are confronted with high risk of sharking as a result of heavy government ownership, lack of prudential regulation, weak legal protection and presence of special interest groups (Arun and Turner, 2003). The independent regulatory agencies are essential in Bangladesh to act against the repeated collusion among government, businesses and bankers to serve special interest groups (Shliefer and Vishny, 1997; Arun and Turner, 2002). However, there is an argument that dynamic role by regulators may cause difficulties as well as regulators may not have a sufficient motivation to monitor the banks as
they do not have much at stake in case of bank failures (Macey and Garrett, 1988). Recently, Bangladesh banking industry has experienced rapid changes due to the growth of wider range of banking products. As a result of this, banks have been involved with high risk activities such as trading in financial markets and different off balance sheet activities more than ever before (Greuning and Bratanovic, 2003), which necessitates an added emphasis on the quality of CG of Bangladesh banking industry.

3.2 Hypotheses Development

The empirical literature on CG and firm performance identified a number of characteristics of CG which influence firm performance. Following is the discussion of some of these characteristics and the hypotheses to be tested.

3.2.1 Board Size

Board size is the most elaborated attribute in the literature, and in general the relationship between board size and performance is found to be inversely related. According to Enobakhane (2010) board size is the total number of directors that an organization has in its board structure. Existing literatures viewed both positive and negative relationship between board size and performance.

Most of the scholars argued that in order to reduce free rider problem in banks’ operation smaller size board are more effective than larger boards (Lipton and Lorsch, 1992, Jensen 1993, Coles et al., 2007, Pathan et al., 2007). Spencer Stuart Board Index (2008) reports that worldwide, board size has been shrinking over the years and that there is a continued trend towards smaller boards. On the other hand, Belkhir (2004), Adams and Mehran (2005) proved that a positive relationship exists between the board size and performance of banking firm by using Tobin’s Q as performance indicator for BHC (Bank Holding companies). Most of the literatures on governance assert that smaller and more outsider-dominated boards are better in corporate management and, thus, contribute positively to corporate performance (Kutubi, 2011).

The problem, however, remains that, it is difficult to determine the optimal size of boards since a lot of factors are taken into consideration in choosing directors. Empirical research has shown that the best board size influencing the firm performance is inconclusive. The possibility of a large board size has the likelihood of having more knowledge and skills at their disposal, which will enhance performance (Williams, 2002). Ramano et al. (2012) argue that when boards grow, they become less likely to function effectively (Jensen, 1993) may create a
diminished sense of individual responsibility and might be more involved in bureaucratic problems. There are the statements which suggest that only an odd number of people can lead a corporation, and three are too many (Vance, 1983, p. 33). For better performance of the financial firm, the board of directors’ role in the banking industry is not only important for the shareholders, but also for other stakeholders importantly for depositors and regulators (Kutubi, 2011). The size and composition of the board of directors constitute the most essential corporate governance themes and have caught the attention of academics and regulators alike (Kutubi, 2011).

The number of the board members shall not be less than 5 (five) and more than 20 (twenty) as per SEC guidelines of 2012. Lipton and Lorsch (1992) state that an optimal board size should be between seven and nine directors to ensure better coordination, accountability, reduce free riding problem and faster decision making which enhances firm performance. This view is supported by other studies (Eisenberg et al., 1998; Yermack, 1996; Sanda et al, 2005) which indicated that the financial market values firms with relatively small board sizes. On the other hand, larger boards would offer the company the opportunity of a pool of talents and wide range of expertise to help make better decision and difficult for powerful CEOs to dominate. However, Jensen (1993), and Lipton and Lorsch (1992) disagree and suggested that larger boards are less effective and easier for powerful CEOs to control.

On the basis of the above literature review and given the large board size in the Bangladeshi banking industry and a relatively less efficient capital market structure (no active takeover threat or M&A), a positive relationship may be expected between the Bangladeshi bank board size and performance.

**H1: The size of the board of directors is positively related to firm performance.**

### 3.2.2 Independent Directors

Empirical research studies present mixed results about relationship between company performance and board independence from different perspectives (Kesner, 1987; Schellenger, Wood and Tashakori, 1989; Zahra & Pearce, 1989; Baysinger & Hoskisson, 1990). Busta (2007) examined a sample of 69 listed banks from France, Germany, Italy, Spain and UK over the period 1996-2005 indicated that banks with a higher presence of non-executives (i.e., independent directors) in their boards perform better in terms of the market-to-book value. Many other researches also support the existence of independent directors in the board for better performance of the banking firm (Helen 2003, Andres and Valletaldo, 2008).
Independent directors are those board members who do not hold any executive position in the company or have any direct or indirect interest in the company (Suchard, 2001). Some argued that existence of independent directors does not have any effect on the performance of a banking firm (Pi and Timme, 1993; Bhagat and Black, 2002, Adams and Mehran, 2005). On the other hand, Helen (2003) argued that for the better performance of the independent directors in the board, five factors (independence, remuneration, qualification, assurance and autonomy) are essential (for the system to work effectively). Andres and Valleslado (2008) argued that inclusion of outside directors improves value in line with board size. Thus, all companies shall encourage effective representation of independent directors on their Board of Directors so that the Board, as a group, includes core competencies considered relevant in the context of each company. Each company shall comply at least one fifth (1/5) of the total number of directors in the company’s board are independent directors. An independent director either does not hold any share in the company or holds less than one percent (1%) shares of the total paid-up shares of the company (SEC Guidelines, 2012). The newly amended Section 15 of the Bank Company Act, 1991 (Amended upto 2013) includes provisions for prior approval of Bangladesh Bank before the appointment of new bank directors and also states that a bank can appoint a maximum of 2 (two) members from a family as director.

As per the agency theory, it is expected that independent directors are able to enhance a board’s monitoring capabilities. Being financially independent of management, these directors have an ability to withstand pressure from management (Hermalin and Weisbach, 1988). Jensen (1983) and Fama and Fama (1980) found that independent directors add value to firms by providing expert knowledge and monitoring services. Indeed, evidence from empirical studies (Brickley et al., 1994; Byrd and Hickman, 1992; Weisbach, 1988) strongly agreed to the crucial role of independent directors in monitoring management performance, offering invaluable advice to shareholders and protecting the interests of shareholders.

In developing countries, the independent directors not only guard the interest of the minority shareholders but also exercise a sobering and constructive influence on running a corporate entity. In the context of Bangladesh, independent directors do not act as an advocate of majority shareholders or as a source of innovative ideas (Bangladesh Enterprise Institute, 2003). But ironically, the companies Act 1994 provides for many stringent rules regarding any negligence, default, breach of duty or trust on the part of directors, managers or officers of a company. But these rules are “more honored in the breach than observance” (Ahmed and
Yusuf, 2005). In addition to this, annual general meetings (AGM) of many listed companies are not held on time, which also implies poor CG (CG) practice.

Therefore, their study took this to test that an optimum combination of executive and non-executive directors is more adequate to create value for the firm than excessively independent boards, because efficient boards would require the presence of executive directors, whose knowledge of the bank could complement non-executive directors’ ability.

According to Enobakhare (2010) board composition is the total number of directors brought from outside the company to sit on the board divided by the board size in a given period. It was chosen as the proxy for CG because literature has found that it has a link with good governance. Board composition is a debated CG issue since it could influence board deliberations and the capability to control top management decisions and results. Although there is not an optimal formula (Vance, 1978), board independence has become a relevant issue in the CG agenda. Actually, non-executive and independent directors considered one of the most important mechanisms for ensuring corporate accountability and firm growth (Ramano et al, 2012). Conversely, De Andres and Vallelado (2008) asserts that an excessive proportion of nonexecutive directors could damage the advisory role of boards since executive directors facilitate the transfer of information between directors and management and give information and knowledge that outside directors would find difficult to gather.

Empirical research affirmed that firms committing financial reporting fraud are more likely to have a poor board of directors dominated by insiders (Farber, 2005; Romano et al., 2012). Many countries have strengthened recommendations on board composition and independence in the companies (Huse, 2005). Importantly, board with many independent directors show a high effectiveness and enhance company performance (Daily & Dalton, 1993).

**H2: Board independence has positive relationship with firm performance.**

### 3.2.3 Board and Management Skills Levels

The role of a board is the internal CG of a firm (Fama, 1980). A board is also a control system in a business (Fama and Jensen, 1983). A board of directors supervising management decisions in an efficient manner will improve firm’s performance. Doing so requires each board member to be fully equipped with management knowledge such as finance, accounting, marketing, information systems, legal issues and other related areas to the decision making process. This requirement implies that the quality of each board member will contribute significantly and
positively to management decisions which is then translated into the firm’s performance (Nicholson and Kiel, 2004; Fairchild and Li, 2005; Adams and Ferreira, 2007). The skill levels of directors and management is very essential for effective performance. They are responsible for the formulation, implementation and evaluation of corporate strategy. These functions have direct effect on the long-term survival of the company. According to Lybaert (1998) better corporate performance is as a result of proven positive relationship of higher levels of education among entrepreneurs and their willingness to use external information, develop networks, make use of consultants or develop more detailed accounting and monitoring. Ideally, if directors and managers should demonstrate the utmost good faith and integrity required of them, then higher skill levels should bring about higher corporate performance.

**H3: The skill levels of board have positive relationship with firm performance.**

**H4: The skill levels of management have positive relationship with firm performance.**

3.1 Audit Committee

Audit committee is one of the sub-committees of the board. It is a very important CG mechanism with the objective of enhancing the credibility and integrity of financial information produced by the company and increasing public confidence in the financial statements. The Audit Committee shall be composed of at least 3 (three) members. As per the Banking Regulation & Policy Department (BPRD) Circular No. 11 (Sec 5.2), the audit committee will comprise a maximum of 05 (five) members, with a minimum of 2 (two) independent directors; the audit committee should hold at least 4 meetings in a year and it can sit any time as it may deem fit; The Board of Directors shall appoint members of the Audit Committee who shall be directors of the company and shall include at least 1 (one) independent director in order to ensure the independence of the audit committee. The Board of Directors shall select 1 (one) member of the Audit Committee to be Chairman of the Audit Committee, who shall be an independent director. Chairman of the audit committee shall remain present in the Annual General Meeting (AGM) (SEC Guidelines, 2012). The establishment of audit committee would lead to better corporate performance. This leads to the fifth and sixth hypotheses:

**H5: The size of audit committee has positive relationship with corporate performance**

**H6: More Independent directors on audit committees have positive relationship with corporate performance**

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Chapter 4

Methodology

A mixed research methodology is applied in this research combining both interpretative and exploratory paradigm to shed light on social reality. Qualitative dimension of the research is limited to testing of selected hypothesis based on the information published in general purpose financial statements across different corporate governance variables and selected parameters to measure performance. To bring triangulation in research and more validity in research outcome, the research extends to address qualitative dimension through the application of netnography and in-depth interview methods.

4.1 Data & Methodology

In support of the quantitative outcome, the researchers have deployed a form of exploratory enquiry to highlight the social reality. Thus the research took a pragmatic approach integrating interpretative approach with positivism. The qualitative dimension of the research draws conclusions based on netnography as a major research methodology supported by ten in-depth interviews. Netnography is an online research method originating in ethnography which is applied to understanding social interaction in contemporary digital communications contexts. It is defined as a specific set of research practices related to data collection, analysis, research ethics, and representation, rooted in participant observation. In netnography, a significant amount of the data originates in and manifests through the digital traces of naturally occurring public conversations recorded by contemporary communications networks. Netnography uses these conversations as data. It is an interpretive research method that adapts the traditional, in-person participant observation techniques of anthropology to the study of interactions and experiences manifesting through digital communications (Kozinets 1998). Snowball sampling method is used to identify the relevant experts for the survey. It helps to bring triangulation in research and ensure content validity in research.

**Type of data:** The data used for this study are derived mainly from the secondary sources. Primary data is also collected through in-depth interview for this study.

**Sample:** The data covers the listed commercial banks. Public commercial banks and foreign commercial banks are excluded from the study to ensure a uniform sample for comparability
and ease of interpretation. For the purpose of measuring different governance characteristics and performance measures, we have included a total of 30 listed commercial banks only.

4.2 Measuring Firm Performance

The key performance indicators chosen to measure performance of banks depend on the interest and justification of the analyst. Performance indicators normally include profitability, efficiency, leverage and liquidity. The study is focused on those measures that are strategically important for the success of the company. The existing literature on CG practices has used accounting-based performance measures, such as return on equity (ROE) and return on assets (ROA), and market-based measures, such as Tobin’s Q, as proxies for firm performance (Abdollah 2004; Bhagat & Black 2002; Daily & Dalton 1993). We measure bank performance by calculating ROA as the income after taxes and provision, divided by the total assets. ROE is calculated as the ratio of profit after taxes and provision divided by the total shareholder’s equity. We also used another bank performance measure which is known as the firm market-to-book value ratio (Tobin’s Q). We calculate it as the book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets as the usual proxy for Tobin’s Q. Many other studies use either this measure or a similar one as the dependent variable in the research for board effectiveness (e.g., Adams and Mehran, 2005; Belkhir 2004, Caprio and Levine, 2002), and in a broader sense, in research of the effectiveness of board composition for the financial firms.

4.3 Model Specification

For the purpose of empirical analysis, this study uses descriptive analysis and liner multiple regression as the underlying statistical test. A descriptive analysis of the data is conducted to obtain sample characteristics. The multiple regression analysis is performed on the dependent variables, ROA, ROE and TQ, to test the relationship between the independent variables with firm performance.
The conceptual model of the study is presented below:

![Diagram](image)

**Figure 8:** Conceptual Framework of the Model

The model identifies the corporate governance variables keeping agency theory in application where agency role of management received the significant attention. Anglo American Model explains that the role of governance is to maximize the firm performance under a single tire governance structure. The following regression models are developed to test the relationship between CG variables and firm performance.

\[
FP_{ROE} = \alpha + \beta_1 BSIZE + \beta_2 BIND + \beta_3 BSKILL + \beta_4 MGT SKILL + \beta_5 ACSIZE + \beta_6 ACCOM + \varepsilon
\]

\[
FP_{ROA} = \alpha + \beta_1 BSIZE + \beta_2 BIND + \beta_3 BSKILL + \beta_4 MGT SKILL + \beta_5 ACSIZE + \beta_6 ACCOM + \varepsilon
\]

\[
TQ = \alpha + \beta_1 BSIZE + \beta_2 BIND + \beta_3 BSKILL + \beta_4 MGT SKILL + \beta_5 ACSIZE + \beta_6 ACCOM + \varepsilon
\]
The following table shows the CG variables and their description in this study.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Description</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Performance Measures</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Asset</td>
<td>Ratio of net profit after tax and provision to the total asset at the end of each year</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
<td>Ratio of net profit after tax and provision to the total equity as at the end of each year</td>
</tr>
<tr>
<td>TQ</td>
<td>Tobin’s Q</td>
<td>Ratio of firm market to book value measured by the book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets.</td>
</tr>
<tr>
<td><strong>Governance Characteristics</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSIZE</td>
<td>Board Size</td>
<td>Total number of directors on the board as at the end of each year</td>
</tr>
<tr>
<td>BIND</td>
<td>Board Independence</td>
<td>Number of Independent directors / Total number of directors</td>
</tr>
<tr>
<td>BSKILL</td>
<td>Board Skill</td>
<td>Number of directors with relevant degrees or professional qualification</td>
</tr>
<tr>
<td>MGT SKILL</td>
<td>Management Skill</td>
<td>Number of management members with relevant degrees or professional qualification</td>
</tr>
<tr>
<td>ACSI DE</td>
<td>Audit committee Size</td>
<td>Numbers of members in audit committee.</td>
</tr>
<tr>
<td>ACCOM</td>
<td>Audit committee composition</td>
<td>Ratio of independent directors in audit committee</td>
</tr>
</tbody>
</table>

*Table 5: Variables, definition and measurement*
Chapter 5
Analysis and Findings

This chapter presents detailed analysis of the data collected and analyzed in line with the hypothesis developed and research methodology mentioned in previous chapters. However, different research methodologies applied to the research gave a common picture of corporate governance in the banking sector of Bangladesh.

5.1 Quantitative Analysis

This section presents the analysis based on the qualitative information collected mostly from general purpose financial statements. The analysis is done to supplement the hypotheses identified for testing.

5.1.1 Descriptive Analysis: The quantitative analysis is based on information gathered with reference to nine different parameters selected. The following table shows the descriptive statistics like range, mean, standard deviation and variance across different variables.

<table>
<thead>
<tr>
<th>Variables in the Study</th>
<th>Range</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td>3.76</td>
<td>-2.04</td>
<td>1.72</td>
<td>0.8979</td>
<td>0.58567</td>
<td>0.343</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>28.16</td>
<td>-2.98</td>
<td>25.19</td>
<td>11.3156</td>
<td>4.72238</td>
<td>22.301</td>
</tr>
<tr>
<td>Tobin's Q</td>
<td>1.24</td>
<td>0.47</td>
<td>1.71</td>
<td>1.0080</td>
<td>0.18308</td>
<td>0.034</td>
</tr>
<tr>
<td>Board Size</td>
<td>13.00</td>
<td>7.00</td>
<td>20.00</td>
<td>13.8333</td>
<td>3.43544</td>
<td>11.802</td>
</tr>
<tr>
<td>Board Independence</td>
<td>0.71</td>
<td>0.00</td>
<td>0.71</td>
<td>0.1909</td>
<td>0.11493</td>
<td>0.013</td>
</tr>
<tr>
<td>Board Skill</td>
<td>3.00</td>
<td>2.00</td>
<td>5.00</td>
<td>4.4833</td>
<td>0.69482</td>
<td>0.483</td>
</tr>
<tr>
<td>Management Skill</td>
<td>3.00</td>
<td>2.00</td>
<td>5.00</td>
<td>4.2000</td>
<td>0.81926</td>
<td>0.671</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>3.00</td>
<td>3.00</td>
<td>6.00</td>
<td>4.3500</td>
<td>0.79883</td>
<td>0.638</td>
</tr>
<tr>
<td>Audit Committee Comp.</td>
<td>0.80</td>
<td>0.20</td>
<td>1.00</td>
<td>0.4542</td>
<td>0.18908</td>
<td>0.036</td>
</tr>
</tbody>
</table>
5.1.2 **Correlation**: This section presents the correlation of selected variables among them. This is very important for application of different inferential techniques based on the dataset. If there is no correlation, the data don’t qualify as the basic criteria of establishing any relationship among them. On scrutiny of the correlation coefficients as produced in the table below, it reveals that there exist relationships among the variables.

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Equity</th>
<th>Tobin's Q</th>
<th>Size</th>
<th>Independence</th>
<th>Skill</th>
<th>Skill</th>
<th>Committee Size</th>
<th>Committee Composition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on Equity</td>
<td>.830</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tobin's Q</td>
<td>.368</td>
<td>.223</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board Size</td>
<td>.224</td>
<td>-.017</td>
<td>.275</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board Independence</td>
<td>.184</td>
<td>.435</td>
<td>-.014</td>
<td>-.450</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board Skill</td>
<td>.599</td>
<td>.404</td>
<td>.318</td>
<td>.215</td>
<td>-.062</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management Skill</td>
<td>.460</td>
<td>.243</td>
<td>.326</td>
<td>.111</td>
<td>-.112</td>
<td>.855</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>-.117</td>
<td>-.245</td>
<td>-.004</td>
<td>.324</td>
<td>-.482</td>
<td>.148</td>
<td>.124</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Audit Committee Comp.</td>
<td>.233</td>
<td>.359</td>
<td>.154</td>
<td>-.209</td>
<td>.713</td>
<td>-.071</td>
<td>-.106</td>
<td>-.621</td>
<td>1</td>
</tr>
</tbody>
</table>

5.1.3 **Regression Analysis**: The study employs regression analysis as an inferential tool to test relevant hypotheses. As per the research methodology, firm performance is assumed to be dependent variable along with different governance related variables as independent one. Firm performance is measured in terms of return on asset (ROA), return on equity (ROE) and Tobin’s Q. Thus three different models are run which resulted in different pattern of relationships. These relationships are discussed below followed by the status of hypothesis testing.
Model 1: Impact of Corporate Governance Variables on Return on Assets

In first model, corporate governance variables are regressed with return on assets. The fit of a multiple regression model can be judged in various ways, for example, calculation of the multiple correlation coefficients or by the examination of residuals. The table below includes some statistics to specify the fit of the model. A measure of the fit of the model is provided by the multiple correlation coefficient, $R$, defined as the correlation between the observed values of the response variable and the values predicted by the model. The value of $R^2$ gives the proportion of the variability of the response variable accounted for by the explanatory variables.

<table>
<thead>
<tr>
<th>Model Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mode</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>1</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Audit Committee Composition, Board Skill, Board Size, Audit Committee Size, Board Independence, Management Skill

b. Dependent Variable: Return on Assets

The above table includes the multiple correlation coefficient, $R$, its square, $R^2$, and an adjusted version of this coefficient as summary measures of model fit. The multiple correlation coefficient $R = 0.695$ indicates that there is a correlation between return on assets and those predicted by the regression model. In terms of variability in observed return on asset accounted for by our fitted model, this amounts to a proportion of $R^2 = 0.482$, or 48.2%. Since by definition $R^2$ will increase when further terms are added to the model even if these do not explain variability in the population, the *adjusted* $R^2$ is an attempt at improved estimation of $R^2$ in the population. The index is adjusted down to compensate for chance increases in $R^2$, with bigger adjustments for larger sets of explanatory variables. Use of this adjusted measure leads to a revised estimate that 42.4% of the variability in level of sophistication in the
population can be explained by the explanatory variables. The table also provides an estimate of the standard deviation of the error term (under “Std. Error of the Estimate”). Here we estimate the mean absolute deviation as .444, which is small considering that the return on asset range from -2.04 to 1.72. Durbin-Watson test is important to check whether there exists any serial autocorrelation. In multiple regression analysis, it has been assumed that the error term is independent with a mean value of zero but in practice, it may happen that the errors are not independent instead *auto-correlated*. If the Durbin–Watson statistic is substantially less than 2, there is evidence of positive serial correlation. The value for Durbin–Watson in this model is 2.328 which clarifies that it doesn’t have any serial autocorrelation.

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>9.764</td>
<td>6</td>
<td>1.627</td>
<td>8.235</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>10.474</td>
<td>53</td>
<td>.198</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>20.238</td>
<td>59</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* a. Predictors: (Constant), Audit Committee Composition, Board Skill, Board Size, Audit Committee Size, Board Independence, Management Skill

b. Dependent Variable: Return on Assets

The ANOVA table as shown above also provides an F-test for the null hypothesis that none of the explanatory variables are related to return on asset, or in other words, that $R^2$ is zero. Here we can clearly reject this null hypothesis ($F(6, 53) = 8.235, p < 0.001$), and so conclude that at least one of the explanatory variables is related to return on asset.

Multiple linear regression is a method of analysis for assessing the strength of the relationship between each of a set of explanatory variables (sometimes known as independent variables, although this is not recommended since the variables are often correlated), and a single response (or dependent) variable. In this model, return on asset is assumed to be explained by selected corporate governance variables and multiple regression is used aptly as an important statistical technique to conclude the explanatory power of different variables in explaining the
firm performance via return on assets. Applying multiple regression analysis to a set of data results in what are known as regression coefficients, one for each explanatory variable. These coefficients give the estimated change in the response variable associated with a unit change in the corresponding explanatory variable, conditional on the other explanatory variables remaining constant. As per the table given below, only one explanatory variables become significant. The standardized beta coefficient of board skill is computed as .646 (p<.005) showing a positive relationship with return on asset. Though not significant, management skill and audit committee size show a negative relationship with return on assets. Other variables show positive relationship but not significant. Thus, we may conclude that only one variable out of six has the explanatory power. For a one unit change in board skill, return on asset will be changed by 0.646.

<table>
<thead>
<tr>
<th>Coefficients*</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td></td>
<td>Std. Error</td>
<td>Beta</td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>-</td>
<td>.634</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1.848</td>
<td></td>
</tr>
<tr>
<td>Board Size</td>
<td>.041</td>
<td>.021</td>
<td>.238</td>
</tr>
<tr>
<td>Board Independence</td>
<td>.926</td>
<td>.814</td>
<td>.182</td>
</tr>
<tr>
<td>Board Skill</td>
<td>.545</td>
<td>.169</td>
<td>.646</td>
</tr>
<tr>
<td>Management Skill</td>
<td>-.051</td>
<td>.140</td>
<td>-.072</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>-.088</td>
<td>.096</td>
<td>-.121</td>
</tr>
<tr>
<td>Audit Committee Composition</td>
<td>.363</td>
<td>.509</td>
<td>.117</td>
</tr>
</tbody>
</table>


Model 2: Impact of Corporate Governance Variables on Return on Equity

Same analysis is done considering return on equity as dependent variable keeping all the independent variables same. The summary statistics are presented in the table below which concludes a similar scenario. The model is again significant with \( R = .646 \) and the value for Durbin-Watson is 2.348 which confirms that serial autocorrelation is absent in the study. The value of \( F \) is also significant at \( p<.001 \). However, as per the beta statistics, like the previous
model, only one variable out of six become significant at $p<.005$. This variable is board skill like the previous one.

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
</tr>
<tr>
<td>(Constant)</td>
<td>-4.442</td>
<td>5.428</td>
<td>.818</td>
</tr>
<tr>
<td>Board Size</td>
<td>.143</td>
<td>.177</td>
<td>.104</td>
</tr>
<tr>
<td>Board Independence</td>
<td>16.974</td>
<td>6.962</td>
<td>.413</td>
</tr>
<tr>
<td>Board Skill</td>
<td>4.393</td>
<td>1.445</td>
<td>.646</td>
</tr>
<tr>
<td>Management Skill</td>
<td>-1.475</td>
<td>1.202</td>
<td>-.256</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>-.751</td>
<td>.822</td>
<td>-.127</td>
</tr>
<tr>
<td>Audit Committee Composition</td>
<td>.662</td>
<td>4.352</td>
<td>.027</td>
</tr>
</tbody>
</table>

R          .646
R Square   .417
Durbin-Watson  2.348
F          6.323
Significance .000
Model 3: Impact of Corporate Governance Variables on Tobin’s Q

This model assumes Tobin’s Q as a proxy to firm performance and run the same analysis considering selected governance variables as dependent ones. The summary statistics are presented in the table below which concludes a different picture. The model reports the value of $R = .474$ and the value for Durbin-Watson 2.032 which confirms that serial autocorrelation is absent from the study. However, the value of $F$ is not significant leaving the model as a poor one. As per the beta statistics, none of the variables become significant.

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
</tr>
<tr>
<td>(Constant)</td>
<td>.365</td>
<td>.243</td>
<td></td>
</tr>
<tr>
<td>Board Size</td>
<td>.014</td>
<td>.008</td>
<td>.264</td>
</tr>
<tr>
<td>Board Independence</td>
<td>-.103</td>
<td>.311</td>
<td>-.065</td>
</tr>
<tr>
<td>Board Skill</td>
<td>.003</td>
<td>.065</td>
<td>.010</td>
</tr>
<tr>
<td>Management Skill</td>
<td>.069</td>
<td>.054</td>
<td>.309</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>.007</td>
<td>.037</td>
<td>.030</td>
</tr>
<tr>
<td>Audit Committee Composition</td>
<td>.298</td>
<td>.195</td>
<td>.308</td>
</tr>
</tbody>
</table>

R  .474
R Square  .225
Durbin-Watson  2.032
F  2.562
Significance  .030
Based on the three models as presented here, the consolidated status of hypothesis testing could be generated as given below:

<table>
<thead>
<tr>
<th>Null Hypothesis</th>
<th>ROA</th>
<th>ROE</th>
<th>TQ</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 The size of the board of directors is positively related to firm performance.</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>2 Board independence has positive relationship with firm performance.</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>3 The skill levels of board have positive relationship with firm performance.</td>
<td>✓</td>
<td>✓</td>
<td>☒</td>
</tr>
<tr>
<td>4 The skill levels of management have positive relationship with firm performance.</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>5 The size of audit committee has positive relationship with corporate performance.</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>6 More Independent directors on audit committees have positive relationship with corporate performance.</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
</tbody>
</table>

The above analysis results that when book value based measure is used to represent firm performance, the model becomes strong and some variables show strong relationship with the dependant variable. However, when market based measure is used as a proxy to firm performance, the model becomes weak with no explanatory variables. This may be due to inefficient market which encourages having some gain through information asymmetry.

5.2 In Search of Reality — An Inquisitive Query

In support of the quantitative outcome, the researchers have deployed a form of exploratory enquiry to highlight the social reality. Thus the research took a pragmatic approach integrating interpretative approach with positivism. The qualitative dimension of the research draws conclusion based on netnography as a major research methodology supported by ten in-depth interviews. Netnography is an online research method originating in ethnography which is applied to understanding social interaction in contemporary digital communications contexts. It
is defined as a specific set of research practices related to data collection, analysis, research ethics, and representation, rooted in participant observation. In netnography, a significant amount of the data originates in and manifests through the digital traces of naturally occurring public conversations recorded by contemporary communications networks. Netnography uses these conversations as data. It is an interpretive research method that adapts the traditional, in-person participant observation techniques of anthropology to the study of interactions and experiences manifesting through digital communications (Kozinets 1998). Snowball sampling method is used to identify the relevant experts for the survey. It helps to bring triangulation in research and ensure content validity.

Banking sector in Bangladesh becomes a promising field to deploy netnography as a research tool. During last couple of years, different online media becomes very active to publish and analyze reports relating to banking debacles. These debacles mainly address cyber heists and non-performing loans. The background of all these stories provides a reflection on firm performance and governance structure which is very much pertinent to the main theme of the research.

5.2.1 Cyber Heist

We had been basking in our success pertaining to the use of cyber space. Most of the innovations in banking industry are based on the use of information technology to serve customers smartly. We did not realize however that there were gaps within our security systems and that the human mind which had created digitalization was also capable of discovering ways and using them to profit from the nuances of cybercrime.

The first rude awakening came after the discovery and complaints filed due to misuse of ATM machines belonging to some Banks and withdrawal from different private accounts of large amounts of money without authorization of the account holders. This led to arrest by the authorities of 14 persons. It included 12 foreign nationals who were members of international cyber crime fraud gang. They had fraudulently used social media platforms and also hacked identity of individual customers to carry out their nefarious act.

This persuaded the Bangladesh Bank to recommend to all Banks and financial institutions to ensure cyber-security governance. They were also urged to take measures for ascertaining existing technical gap assessment and vulnerability through a comprehensive cyber security risk study. In this context the Bangladesh Bank also reiterated that cyber security should be treated by all financial institutions as a collective responsibility. It was also acknowledged by
the Central Bank that “Bangladesh remains vulnerable to cyber-attacks because traditional
cyber defenses such as anti-virus software and firewalls are proving ineffective against new
threat vectors such as zero-day-malware and Advanced Persistent Threats (APT)”. Such
measures were recommended by the Bangladesh Bank because such cyber attacks were seen as
being capable of causing financial loss and creating a reputational risk. This was an indirect
acknowledgement of actors in the cyber scene who might be independent individual hackers or
part of a sophisticated well-resourced crime syndicate.

However, the disappointing aspect of this sermon from the Bangladesh Bank was that, while
giving necessary advice to all concerned, they had forgotten to heed their own suggestions and
failed to take adequate precaution of their own institution and its relationship with other
associated financial partners abroad. This failure on their part had been kept confidential and
away from the Bangladesh media.

The first hint of trouble came through media reports originating from the Philippine Daily
Inquirer which reported on 29 February that Philippine financial regulators were investigating
an estimated US$ 100 million bank heist. The newspaper also mentioned that Bangladeshi
authorities had obtained requisite information that the stolen funds were wired through the Fed
to the Rizal Commercial Banking Corporation (RCBC) in the Philippines. From there, the cash
was transferred to at least three Filipino casinos: Solaire Resort and Casino, City of Dreams,
and Midas. At the casinos, someone converted the cash into chips for betting and then
reconverted the chips into cash. This money was then sent to bank accounts in Hong Kong. An
additional fund of about US$ 21 million was also transferred illegally to a third party in Sri
Lanka.

After that the story gradually surfaced. Subsequently, the Bangladeshi media revealed that the
false transfer orders to Philippines included fraudulent payment orders of US$ 25 million for
the Kanchpur, Meghna and Gumti 2nd Bridge Construction Project, US$ 30 million for the
Dhaka Mass Rapid Transport Development Project, US$ 6 million for the IPFF project cell and
US$ 19 million for the Bheramara Combined Cycle Power Plant Development Project. A
ranking official of Pagcor, which is in charge of regulating gaming activities in Philippines has
said that the funds were split into a $26-million tranche that was channeled into the account of
Solaire Resort and Casino and a $20-million tranche that was directed to the accounts of Easter
Hawaii Casino and Resort at the Cagayan Economic Zone Authority in Santa Ana, Cagayan
province. The two tranches, totaling $46 million represented 56 percent of the stolen money
that entered the Philippine financial system between Feb. 5 and Feb 9, 2016.
An analyst on cybercrime noted that the perpetrators of the approximate US$100 million digital heist from the reserves of the Bangladesh’s central bank had deep knowledge of the institution's internal workings, likely gained by spying on bank workers. Unknown hackers, it turned out had breached the Bangladesh Bank account on 4 February, stole credentials for payment transfers and then ordered transfers out of a Federal Reserve Bank of New York account held by Bangladesh Bank. As expected, the Bangladesh government officials blamed the Fed for the attack when they disclosed the loss. The New York Fed responded by saying there was no evidence that its systems were compromised in the attack - one of the biggest bank thefts in history. The Fed also pointed out that it had followed normal procedures when responding to requests that appeared to be from Bangladesh Bank. This was done because the course of action was made and authenticated over SWIFT. Belgian-based SWIFT, it may be noted is a member-owned cooperative that Banks use for account transfer requests and other secure messages. Security experts of the Fed also commented that to pull off the attack, cyber criminals had to first gather information about Bangladesh Bank's procedures for ordering transfers, so that the fraudulent requests would not raise red flags. In addition, experts in banking fraud also mentioned that to stealing credentials for processing transfers, the hackers, in all likelihood also spied on Bangladesh Bank staff to get a deeper understanding of the central bank's operations. There was also the possibility that some of them might have discreetly assisted in the hacking process. A senior Director with security firm RSA also indicated that in addition to user names and passwords for accessing SWIFT, the hackers likely needed to obtain cryptographic keys that authenticated the senders. Such certificates might have been copied and used by impostors if they were not properly secured.

The Bangladesh Finance Minister has gone on record that he as well as the Bank and Financial Institutions Division Secretary had been kept in the dark by the Bangladesh Bank about the crisis. One has to agree with him that this was totally unacceptable. An expert on financial market commented that it is a pure reflection of causality on part of regulator who was busy with regulatory role only without ensuring any harmonization on its own operation.

We must not have a repeat of the mal-governance that we have witnessed in the case of recovery of lost funds through scams carried out in the Sonali Bank, the BASIC Bank, the Hall Mark Group, the Bismillah Group and some other institutions. Lack of dispensation of justice with regard to the criminal activities carried by these Groups in collaboration with corrupt Bank officials still continue to irritate public opinion. An eminent scholar of finance (university professor) acknowledges that the major borrowers have relationship with the top level of banks and sometimes this becomes the only criteria of creditworthiness.
Interestingly it was also revealed in the second week of March that most fortunately, though
the hackers had tried to transfer illegally another $870 million from the Bangladesh Bank’s
account at the Fed, they had been unable to carry out their operations through the international
banking system because regulators detected that something was fishy and blocked the transfer.
A spelling mistake prevented the illegal shifting of money. Apparently the hackers misspelled
the name of the NGO to whom the money was going to be transferred. Instead of “foundation”
the hackers had spelt it as “fandation”. This prompted a routing Bank- Deutsche Bank to seek
clarification from the Bangladesh Bank, which stopped the transaction.

The seriousness of the situation is indicated by the fact that last year, Russia’s computer
security company, Kaspersky Lab informed that a gang of cyber criminals had stolen as much
as US$ 1 billion from nearly 100 financial institutions around the world over the previous two
years. The hard-working people of Bangladesh have now been victims of such a carefully pre-
planned scam that saw five Philippine nationals open five US Dollar accounts in a Philippines
Bank for the purpose of defrauding Bangladesh Bank on 15 May, 2015. It has also been learnt
that hackers installed malicious software into the Bangladesh Bank system in January, 2016.
This helped them to gain knowledge of the Bangladesh Bank’s working methods before
initiating the process of the heist.

It is understood that the Bangladesh Bank has sought cooperation from the Federal Bureau of
Investigation to recover the stolen funds. US Embassy Officials in Dhaka have apparently
responded positively. In addition, experienced information technology consultants from the
World Bank and Bangladesh have also been appointed to help investigate and collect
information on the existing cyber security system (that assists in the functioning of the back
office) related to the Accounts and Budgeting Department of the Bangladesh Bank. FireEye
Inc’s Mandiant Forensics Division is also helping in the investigation. Experts believe that on
conclusion of the current inquiry, steps will be taken by the Bank to install new software to
make the Bangladesh Bank activities safer.
Unfortunately, while the Bangladesh Bank was so pro-active in advising how to stop ATM fraud in other financial institutions, it forgot that the adage “Prevention is better than cure” also applies to them. Cybercrimes, we need to remember, cover a range of offences that are committed against individuals or groups of individuals with a criminal motive to intentionally harm the reputation of the victim or cause physical or mental harm, or loss, to the victim directly or indirectly, using modern telecommunication networks. Due to easily exploitable laws, cybercriminals use developing countries in order to evade detection and prosecution from law enforcement. Laws against cybercrime in these countries are weak or sometimes nonexistent. Such crimes may threaten a nation’s security and financial health. It is also clear that both governmental and non-state actors engage in cybercrimes, including espionage, financial theft, and other cross-border crimes. Unfortunately, it appears that the regulatory regime regarding control of cybercrime or server management (in the case of e-commerce) is weak in Bangladesh. It might be useful to seriously study the European Union Directive 2013/40/EU, the offences enumerated within the Directive and other definitions and procedural institutions as enumerated in the Council of Europe’s Convention on Cybercrime.

Evidence of hacking in commercial banks demonstrates corruption in the government's procurement framework where unqualified vendors were selected without proper evaluation of

Exhibit 1: A Glimpse on Attacks

In the last few years, the banking sector in Bangladesh was the victim of several security breaches:

- On January 06, 2013, Islami Bank Bangladesh site was hacked by Human Mind Cracker.
- In 2015, bank accounts of a private bank were hacked and money was withdrawn from them.
- On December 2, 2015, Hackers breached the network security of Sonali Bank and took control of its website for a couple of hours.
- In February, 2016, skimming attacks took place in six ATM booths of three commercial banks.
- And the largest e-money laundering in the history of banking occurred in February 2016, when hackers stole $101 million from the Bangladesh bank's account with the Federal Reserve Bank of New York.
skills and consultation of IT experts. It is surely a breach of IT governance which may bring severe financial penalty, and which actually brought.

5.2.2 Non-Performing Loans
Along with the cyber heist, another major concern for banking industry is non-performing loans. Banking sector grapples with staggering amount of Tk. 63,365cr as reform efforts fail to curb bad loan culture; situation worse at state-owned banks.

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan Defaults (in crores of Taka)</th>
<th>Default Trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>12,624</td>
<td>13.23</td>
</tr>
<tr>
<td>2008</td>
<td>22,481</td>
<td>10.79</td>
</tr>
<tr>
<td>2009</td>
<td>22,482</td>
<td>9.21</td>
</tr>
<tr>
<td>2010</td>
<td>22,709</td>
<td>7.27</td>
</tr>
<tr>
<td>2011</td>
<td>22,644</td>
<td>6.12</td>
</tr>
<tr>
<td>2012</td>
<td>42,725</td>
<td>10.03</td>
</tr>
<tr>
<td>2013</td>
<td>40,583</td>
<td>8.93</td>
</tr>
<tr>
<td>2014</td>
<td>50,155</td>
<td>9.69</td>
</tr>
<tr>
<td>2015</td>
<td>51,321</td>
<td>8.79</td>
</tr>
<tr>
<td>2016</td>
<td>63,365</td>
<td>10.06</td>
</tr>
</tbody>
</table>

Default loans have dogged the country's banking sector for nearly three decades now, despite various reform efforts, in an alarming pattern that has damaged the economy and deprived honest borrowers of funds. As of June, defaults amounted to Tk. 63,365 crore, which is 10.06 percent of the total outstanding loans, according to the latest data from Bangladesh Bank.

If the written-off and rescheduled loans are taken into account, the sum would easily cross the Tk. 100,000 crore-mark. Thanks to the growing default culture, banks are losing out on
revenues: they have to make provisioning against the bad loans from their incomes. And the situation is particularly dire at state banks, which need capital injection from taxpayers' money every year to stay alive. At the end of the first quarter of 2016, the nonperforming loans of state-owned commercial banks stood at 24.27 percent. In contrast, it was 6.2 percent in neighboring India. The default loan situation improved when the new government assumed power in 2009, with the bad loan ratio coming down to a single digit. But in June this year, it again crept up to double digits. Economists and former central bankers have termed the situation alarming (Byron and Rahman, 2016).

**History of Defaults**

Default loans have always been around, with some of the loans being classified as early as the 1970s. At the time, the BB as well as the banks themselves classified the loans, and once they were realized they would be de-classified automatically. But from the 1980s, classified loans started to rise, soaring as high as 35 percent, according to a former deputy governor of the central bank. The situation mounted pressure on the BB to classify loans based on international best practices, and subsequently new rules were introduced in 1989. Under the new rules, the size of the classified loans expanded significantly, said a former managing director of Pubali Bank. This prompted the government to undertake a reform project under the supervision of the World Bank in 1991-95. In 1996, the then government formed a banking reform committee, which found the default loan situation to be severe, especially at state banks. In 1993, default loans at state banks stood at 32 percent and rose to 47 percent in 1999. And in some troubled private banks, classified loans were as high as 50 percent. But total default loans at private banks came down to 29 percent from 35 percent during the period.

In its observation, the committee said that despite undertaking a host of reform initiatives in the banking sector, the desired result could not be achieved because of various problems and limitations. About the state banks, it said they turned unprofitable and their net worth was negative as well. It also said the huge default loans had turned the banking sector risky and became a barrier to boosting investment in the economy and making effective use of capital. In 2003, the BB issued a notice on loan write-offs that allowed banks to somewhat shrink their default loans overnight. Default loans stood at 13.23 percent of total loans in December 2007.

When the new government came to power in 2009, it was 9.21 percent. In 2011, it even came down to 6.12 percent. The lower ratio of default loans though was not because of recovery; it
was largely because of write-offs and rescheduling. At the end of 2009, the amount of loans written-off was Tk. 15,667 crore. Since 2011, there have been ups and downs. As of December 31, 2015, Tk. 40,361 crore was written off. In 2015, the BB, under pressure from large businesses, gave restructuring facility to loans upwards of Tk. 500 crore. Under the facility, Tk. 16,401 crore has been rescheduled.

Factors that Affect Default Loans

A former BB governor said the problem was created because the loans were given through anomalies and corrupt practices. It is the acknowledgement of the existence of governance crises by an experienced official. Furthermore, the loans were never monitored, and actions were not taken to realize them even when the banks came to know that they had become default. He also mentioned,

“The factors that caused the default loans have not been removed - the necessary actions have also not been taken.”

He said the banks are largely responsible for the default loans. They have continued to give loans in the same manner: under various influences and without looking at the quality of borrowers. And when the loans become default, the banks find ways to keep provision against them. The former BB governor said political influence works in two ways: when taking loans and preventing banks from taking actions, and when the loans turn bad. A lead economist of the WB's Dhaka office mentioned ‘if credits are not extended properly to borrowers capable of using the money in the right business, the quality of assets created out of loan liabilities can never be ensured’.

Poor governance at bank boards, inadequate credit information, and inadequate financial statements of borrowers are major factors contributing to poor asset quality, according to an International Monetary Fund report on Bangladesh in January 2016. Moreover, lengthy legal procedures involving disputed loans make it very difficult for banks to recover value from NPLs or their collateral, further exacerbating loan losses, the report said. In this regard, a veteran banker said loans can turn bad unintentionally, through external shocks such as the sudden fall in commodity prices.

The banking reforms committee of the mid-1990s had identified state banks as the most problematic area and nothing has changed in the two decades. Once a high performer, BASIC
Bank has been reduced to a bad bank after appointment of corrupt people on its board. Another
government controlled bank, Bangladesh Commerce Bank, which was set up in 1995, saw its
default loans soar to 32 percent of its total loans in June this year. The situation is the same in
other state banks.

Since assuming office in 2009, the then government in many cases appointed board members
on political considerations; even though the last national banking advisory committee formed
by the government recommended that a panel of qualified people should pick directors. A
former banker cited the reappointment of Agrani Bank Managing Director as a case in point.
The Banking Companies Act has made obtaining a “no-objection” letter from the central bank
mandatory when appointing managing directors of both state and private banks. For mentioned
reappointment, the BB never gave the letter because of corruption allegations against him, but
the finance ministry still went ahead and reappointed him. The Banking Division even justified
the move by saying that the government is the owner of state banks, so it made the
reappointment.

“The central bank could do nothing here. When the finance ministry defies the law to pave the
way for appointing a corrupt person, then why will corruption not take place?” said the former
banker. He noted that loans may turn bad because of unrest or other unavoidable situations in
the country. But when a loan is given out through corrupt practices, it becomes bad from the
very first day. He said the central bank should shoulder some of the blame as it has distanced
itself to some extent from core banking. There was a lack of monitoring and supervising of the
banking system on the BB's part, and no follow-up actions were taken at the right time, he said.

A commissioner of Bangladesh Securities and Exchange Commission said the large and ever-
increasing accumulation of non-performing and stressed assets in state-owned banks hinder
their capacity to provide fresh loans. The repeated application of rescheduling and write-offs
for reducing classified loans on banks' balance sheets has not yielded the intended results yet.
He mentioned,

Such techniques work only when they are applied in truly deserving cases without
repetition. Once you start rescheduling the rescheduled loans, a Pandora's box opens.

It reduces the perceived cost of not repaying loans on time, thus encouraging and deepening
the default culture, he added. The IMF in January said the high NPLs, low loan recovery ratios
and the correspondingly large provisions for loan losses are an important driver of interest rate
spread in Bangladesh. It is estimated that halving loan loss provisions from their end-2013
level (through an improvement in asset quality) would help bring down lending rates by 0.4 percentage points.

An eminent banker said one provision of the Banking Companies Act has to be changed. According to the provision, the central bank can remove chairman, MD or board members and even dissolve the board and appoint administrator if their actions go against depositors or the banks. At the same time, it is said that if the board members or the chairman are appointed by the government, the central bank will not be able to apply any power. He said,

It is an arbitrarily black law. How come two laws exist in the country? The law has to be amended and the central bank should be allowed to exercise its quasi-judicial power on all banks.

He also said the Banking Division should be made void and a search committee formed with noted economists or former governors to appoint MDs or chairmen. “Corruption has proliferated after the Banking Division was formed.” He said the recapitalisation of state banks with taxpayers' money when they face a capital shortfall should be stopped. “The banks have to earn money to meet the shortfall.”

In a study, the Bangladesh Institute of Bank Management said unconditional recapitalisation provides no incentive for doing some deep surgery to repair the banks' damaged balance sheets. In the long run, rising stress in the state banks will require more radical reforms in their structure of governance. The fundamental problems with the state banks are the interdependence between banks and state-owned enterprises, the way that banks are run as SOEs, and the government's improper influences on the operations of SOEs and banks, the WB said. Also, many private industrial companies have been hit by delays in making their investment projects operational due to unavailability of basic utility connections such as gas, water and electricity, leaving them unable to repay loans to SCBs. “Though these problems have been around for a long time and are deeply rooted, they have never really been solved,” the WB said.

Without a thorough reform of the SOEs and the way that banks are run as SOEs, the problems with the banking system will remain, even after the banks are fully or partially relieved of current NPL, the Washington-based multilateral lender said. Subsequently, it suggested strengthening the independence and accountability of state banks' boards, shoring up their
balance sheets through recapitalisation conditional on improved loan recovery and temporary credit growth limits, and speeding completion of branch automation to strengthen financial reporting and efficiency.

It also called for enhancing financial sector regulation and supervision by strictly enforcing existing rules and avoiding regulatory forbearance, and completing implementation of risk-based supervision and contingency planning. The WB called for improving the legal and financial framework for loan recovery. The difficulties in realising collateral and lengthy dispute resolution processes have weakened the banks' ability to bring down NPLs. “It is critical to institute simpler court procedures, alternative dispute resolution mechanisms, and asset management companies,” the WB said. To ensure sustainable and prudent credit operations, more innovative approaches, along with judicial use of rescheduling and write-off, are needed to end the default culture. The willful defaulters must be held accountable, not rewarded through rescheduling.

### 5.2.3 Money Laundering

Another concern in banking sector is money laundering. A Centre for Policy Dialogue (CPD) survey confirms, more than 60% large entrepreneurs strongly agreed that money laundering was taking place through formal banking system in Bangladesh extensively. Nearly 61% entrepreneurs feared that the investment environment could deteriorate further in coming days. They (entrepreneurs) also mentioned that corruption, inadequate infrastructure, inefficient government bureaucracy, government instability and limited access to financing are the major impediments towards private investment. CPD presented the survey report at a media briefing on State of the Bangladesh Economy in FY2014-15 (Third Reading) as part of CPD’s Independent Review of Bangladesh’s Development (IRBD) program.

Given the high interest on lending charged by the domestic banking sector, over 53% supported allowing foreign loans for private investment to a great extent. The survey also revealed that 67.8% respondents possessed a rather pessimistic view as regards the ongoing initiatives to improve infrastructure in Bangladesh and 76.7% expressed doubt over the prospects of timely implementation of infrastructure projects. Executive Director of CPD said,

Much of the capital flight might occur through under-invoicing of capital machinery and those items with zero duty.
After analyzing import shipment data of 30 items for July-March, the CPD like previous year indicated that the possibility of illicit financial flow through import of capital machinery was taking place. It found that growth payments jumped abnormally 23% against capital machinery import during the first nine months of the current fiscal year. This rise in imports of capital machinery failed to reflect in private investment, which is still perceived to be stagnating, it said. The survey was also identified that 30 import items valued more than Tk. 100 crore witnessed 100% growth during the period. More precisely, four of the items in categories of aeroplanes and other aircraft, compression-ignition internal combustion piston engines, and machines for treating metal including electric wire and transformers, showed very high growth in their value, it said.

5.2.4 Challenges of Banking Sector

Banking sector in Bangladesh has come across a turbulent year facing many odds and pitfalls in the macroeconomic fundamentals. The major challenges faced by the banking industry were low credit growth, increasing trend of non-performing loans resulting in higher provisioning requirements, and surplus liquidity. The cumulative effects of these put pressure on the profitability of the banking sector as a whole.

Domestic credit growth (Point to Point) was 10.78 per cent in October-end, 2013 against that of 16.85 per cent of the previous period. Private sector credit during the period registered slightly over 11 percent growth against 18.38 per cent over previous period. However, deposit growth (Point to Point) was over 18 per cent in October-end, 2013 against that of 19 per cent over the previous year. Consequently, a considerable gap has been created in sources and uses of fund of the banking sector. As a result, the industry has been burdened with liquidity surplus. Total liquid asset of the banking sector in October-end, 2013 stood at Tk. 1860 billion which was more than 1.86 times higher than the required statutory liquidity ratio (SLR). With the same token, Advance Deposit Ratio (ADR) of the sector reduced to 71.70 per cent in September-end, 2013 against 76.59 per cent in December-end 2012 where ADR of Private Commercial Banks (PCB) reduced to stand at 77 per cent against 79.65 per cent of the same period.

Despite low credit growth, non-performing loan (NPL) had continually been increasing at an increasing rate and reached to a record high of Tk. 567 billion in September-end, 2013 registering around 33 per cent increase over December-end, 2012. Consequently NPL ratio increased to stand at around 13 per cent in September-end, 2013 against slightly over 10 per cent of December-end, 2012. Although State-Owned Commercial Banks (SCB) contribute the
major portion in the classified loan portfolio pie (43 per cent reflecting around 29 per cent NPL ratio), PCBs had been affected more during the period. Non-performing loan of PCBs increased to Tk. 223 billion in September-end, 2013 against Tk. 130 billion in December-end, 2012 reflecting more than 70 per cent increase. The NPL ratio of PCBs, which was within a tolerable limit for more than a decade, reached a record high of 7.30 per cent in September-end, 2013 against 4.58 per cent in December-end, 2012. This deterioration of asset quality adversely affected the resilience capacity of the PCBs.

Consequent to increase in NPL, the provisioning requirement increased by 32 per cent to stand at Tk. 320 billion in September-end 2013, against December-end, 2012 where required provision of PCBs increased to Tk. 117.60 billion registering 40 per cent growth.

As a consequence of low credit growth and high non-performing loan, coupled with increased interest/profit expenses for additional mobilised deposit, profitability of the industry has been adversely affected. Un-audited operating profit figure of a good number of banks registered negative growth in 2013 over 2012. Return on asset (ROA) decreased to 0.44 per cent in 2013 from 0.92 per cent in 2012 while return on equity reduced to 5.03 per cent from 10.17 per cent of the previous year.

Considering the likely disastrous performance of the banking sector, Bangladesh Bank (BB) at the far end of 2013 relaxed the loan rescheduling policy for the next six months to facilitate financing for the businesses, affected by political unrest. Under this directive, BB has allowed banks to reschedule loans by fixing their down payment and time limit for repayment on the basis of banker-customer relationship after taking NOC (No Objection Certificate) from the central bank. Thus, banks have got enough room to improve the asset quality through rescheduling and add back provision requirements for showing better financial performance than anticipated. Many of the banking industry experts are of the opinion that random implementation of the directive would increase 'paper profit' and might put the banks in jeopardy in the long run. Thus banks should use their prudence in capitalising the same.

Banking sector will be under tremendous pressure to make effective utilization of funds to bring the ADR at the optimum level. In order to enhance income, banks will be under stress to increase the credit growth with the surplus fund and projected additional deposits to be mobilised in the current year. On the other hand, maintenance of asset quality will always come as a priority issue not only for the existing credit portfolio but also for new one.

The prime focus of the banking sector would be the recovery of rescheduled loans that has been made during last part of the previous year through the central bank's directive. If the
banks are unable to make them perform within the relaxation period, a good amount of additional provision might be required that might put the banks in a distress situation.

Bangladesh Bank is in the process of implementing Supervisory Review Process through Internal Capital Adequacy Assessment Process (ICAAP). Under the above directive, banks need to keep additional capital against residual risk, credit concentration risk, liquidity risk, strategic risk, reputation risk, settlement risk, evaluation of core risk management and environmental and climate change risk in addition to credit/investment, market and operational risk. The average Capital Adequacy Ratio of PCBs was slightly over 11.50 per cent against minimum requirement of 10 per cent. The increased capital requirement under ICAAP might put pressure on capital requirement of a good number of banks having marginal capital adequacy.
Chapter 6

Conclusions and Recommendations

Corporate governance and its impact on financial performance received the highest level of research attention to both researchers and regulators. Abundant research papers addressed this issue considering different sectors, particularly bank. As banks are the reservoir of financial resources in every country, economic development of an economy mostly depends on the sound health of banking sector. Banking sector in Bangladesh has been suffering from different problems and thus a research was undertaken to reveal the background of such, specially the impact of corporate governance in its performance.

One of the problems that banks, particularly state-owned commercial banks face at present is that of dealing with the high volume of non-performing loans. Though Bangladesh Bank adopted a flexible loan-rescheduling policy in December 2013 in order to provide respite to borrowers in view of the political turmoil and reduce the burden of non-performing loan on banks, the policy did not lead to fruition. Rather, the amount of non-performing loan has increased partly due to the flexible loan scheduling policy itself. Lack of proper screening of loan proposals and due diligence, non-adherence to project selection criteria, consideration of non-economic factors in sanctioning loans and lack of monitoring during project implementation are the major reasons behind high non-performing loan in Bangladesh.

The high volume of non-performing loan is taking a toll on capital adequacy and profitability of banks. Capital adequacy ratio, measured as capital to risk weighted assets, is below the international standard of maintaining a minimum capital adequacy ratio of 10 per cent in state-owned banks. Non-performing loan coupled with lower demand for loan has affected the profitability of most banks. Return on asset and return on equity have been negligible and even negative in state-owned banks. This not only reflects the quality of assets in the banking system, but also raises concerns about the sustainability of these banks.

With generous support from the government, state-owned banks were able to adjust their accounts and make up for their losses created through various financial malpractices. In order to strengthen the banking sector, Tk. 5,000 crore was earmarked in the national budget. While the government is injecting capital into these troubled banks in order to keep them afloat, allocation for other priority areas including social sectors remain less than adequate. On the other hand, though financial inclusion in terms of population per bank branch has improved over the years, a large number of people still remain outside the purview of banking services. Thus, recapitalisation of these banks raises questions as regards the prioritisation of the
allocation of public resources, particularly when state owned banks continue to be fraught with governance challenges. The fact that such capital infusion has not seen any improvement in the receiving banks is rather frustrating.

In a bid to improve the performance of the banking sector the government of Bangladesh embarked on a policy of liberalisation through denationalising the nationalised commercial banks in the 1980s. In view of the deteriorated performance and inefficient resource management the government decided to open up the banking sector and adopt a number of reforms for the sector. As part of the reform process two of the six nationalised commercial banks were denationalised and a few commercial banks were given license to operate in the private sector to create competition in the banking sector. The reform process accelerated towards the end of 1980s and the beginning of the 1990s under the directions of the World Bank and the International Monetary Fund. The National Commission on Money, Banking and Credit was constituted in 1986 to look into the problems of the banking sector and suggest ways to overcome those under the direction of the World Bank. The Commission pointed out, among others, problems relating to the supervisory task of Bangladesh Bank and overall structure of the banking sector, and pointed out that non-performing assets required improvement. The consequent Financial Sector Reform Programme and Financial Sector Adjustment Credit carried out in the 1990s were geared towards implementation of various reform measures in the financial sector. The objectives of these measures were to liberalise interest rate, enhance the capacity of loan classification and provisioning, capital restructuring and risk analysis, strengthening the central bank, and improving the legal system and framework for loan recovery.

Following the phase out of the Financial Sector Reform Programme in 1996, subsequent governments continued to undertake reform measures in the financial sector. The Commission on Banking and the Banking Reform Committee were formed in 1998 and 2002 respectively to make recommendations for the improvement of the performance of banks. A bill was passed in the parliament in 2003 to bring more reforms in the banking sector. Most important of the relevant initiatives was the Bangladesh Bank Amendment Bill, 2003 through which Bangladesh Bank received the autonomy to operate on its own and to formulate the monetary policy. The World Bank and the government of Bangladesh undertook a reform initiative called the Central Bank Strengthening Project to put in place a strong and effective regulatory and supervisory system for the banking sector of the country. The focus of this project was on three broad areas, those of (i) strengthening the legal framework; (ii) reorganisation and modernisation of Bangladesh Bank, and (iii) capacity building of Bangladesh Bank.
Another major reform attempt was the corporatisation of four state-owned banks into limited companies and restructuring of three state-owned banks in 2007 to operate as more of a commercial entity. Supported by the World Bank and monitored by the Bangladesh Bank, the reform initiative included measures such as selection of the chief executive officer, deputy managing director and four general managers of the state-owned banks through a competitive process, and fixation of the compensation package that was commensurate with the private sector and in accordance with respective performance records. Monitorable goals were set for cash recovery of non-performing loans, limits on new non-performing loans, operations, computerisation, income and profitability, increased net worth and disclosure.

However, the reform initiatives for the banking sector in Bangladesh have not been able to deliver the expected results. Achievements in terms of efficient resource allocation through disbursement of credit to productive sectors, prudent risk analysis, supervisory and management quality have not been encouraging in many banks even after so many reforms since independence. Moreover, lack of governance has featured prominently in the recent years in several banks including the state-owned banks.

Following the unprecedented level of misappropriation by the Hallmark group in 2012 from a state owned bank, a number of incidences of malpractices have been unearthed in other banks. These incidences have exposed serious flaws in the governance of the sector, the associated corruption in the sector and negligence of the responsible people. Sadly, the sector has not been able to make any visible progress in terms of restoring governance since the Hallmark incidence.

Ironically, in most cases, these incidences have occurred in collaboration with officials and directors of banks through various types of dubious practices such as by setting up fake companies, forging bank documents, documenting fake board meetings and influencing the monitoring officials. Private commercial banks are not unscathed either. Fraudulent activities, which owners and the management have been party to, are also observed in these banks. This has compelled the central bank to appoint observers in a few banks.

After several reforms in the banking sector since the eighties, the banking sector had begun to exhibit some signs of improvement in a few areas. However, recent shocks have exposed the fragility of the sector and pointed out that reforms in the sector have been incomplete. If the banking sector has to contribute to the economic growth of the country through mobilising resources for investment in productive sectors, it needs a massive overhauling and clean up. The required measures can be categorised into three broad areas – (i) strengthening internal governance of banks; (ii) improving oversight function; (iii) removing political influence.
Most banks suffer from shortcomings such as poor selection of creditors and politically motivated lending, poor risk management, lack of due diligence, weak monitoring and misreporting. There is a lack of transparency and accountability in case of credit approval, administration, monitoring and recovery processes. Credit concentration is common in many banks. Concentration of outstanding loans in the hands of a few business groups indicates high level of risk and vulnerability in the sector. This has exposed banks to high default risks. Given that a significant proportion of this loan is non-performing loan as highlighted above, this raises serious doubts in regards to the quality of credits.

In view of the recent shocks in the banking sector and emerging challenges, a commission for the financial sector should be formed which will scrutinise the overall performance of the sector, assess the needs of customers and the economy, identify the current problems and emerging challenges, and suggest concrete recommendations for prudential banking to be implemented in the short to medium terms. Considering the emerging need and in order to build up more transparent and responsible banking sector, the commission can also include non-banking financial institutions such as insurance companies and the capital market under its jurisdiction as they are interconnected. The broad terms of reference of the Commission will be to critically assess the problems and weaknesses of the banking industry in order to find whether there is any disconnect between demands of the growing economy and the realities of a backdated financial system that is failing to meet the emerging needs. On the basis of a comprehensive scrutiny the commission will prepare guidelines and make recommendations as regards automation, risk management, internal control and the role of various players in banks and other financial institutions.

As the country desires to step into a higher growth momentum through exploring its potentials, the demands on the banking sector will continue to be higher in the coming days. This reiterates the need for improved efficiency of the sector. This has become important also due to the fact that the global regulatory environment is becoming tighter; the global economic environment is facing more volatility and resources are becoming scarce. There will be demands for higher capital and skilled human resources for smooth functioning of banks and for ensuring compliance in the future. Hence the banking sector in Bangladesh will have to focus on using both its financial and human resources in a far more innovative, judicious and efficient way to cater to the future demands.
Recommendations

The current research would like to draw some broad recommendations based on the analysis and believe that these recommendations have policy implications:

a) Regulators should ensure strong level of monitoring and necessary actions so that governance mechanism gets strengthened in both state-owned and private commercial banks.

b) Decision based on political considerations should be avoided.

c) Regulatory gaps between state-owned and private commercial banks should be eliminated for ensuring fair and competitive play.

d) Time has come to accommodate theories other than Agency Theory to bring a new regime of governance.

e) Anglo-American model of corporate governance needs careful revision so that two tier boards may be prescribed to ensure transparency.

f) A move from external focus to internal focus becomes a prime requirement.

g) Regulatory provisions across different guidelines like Bangladesh Bank, Bangladesh Securities and Exchange Commission and Banking Company Act need careful alignment.

The weak relationship between performance and different governance related variables (except board skill) signifies that banking sector in Bangladesh failed to get any financial outcome due to the application of governance. The qualitative part of the study also confirms the similar outcome. Behind all the problems like cyber crime, loan defaulting, money laundering, the one and important factor that become responsible is weak governance system in banking sector. Some of the important statements are reproduced below from the analysis to raise more concerns to the requirement of ideal governance mechanism in banks:

- We must not have a repeat of the mal-governance that we have witnessed in the case of recovery of lost funds through scams carried out in the Sonali Bank, the BASIC Bank, the Hall Mark Group, the Bismillah Group and some other institutions.

- An eminent scholar of finance (university professor) acknowledges that the major borrowers have relationship with the top level of banks and sometimes this becomes the only criteria of creditworthiness.

- Evidence of hacking in commercial banks demonstrates corruption in the government's procurement framework where unqualified vendors were selected without proper evaluation of skills and consultation of IT experts. It is surely a breach of IT governance which may bring severe financial penalty, and which actually brought it in some cases.
• A former BB governor said the problem was created because the loans were given through anomalies and corrupt practices. It is the acknowledgement of the existence of governance crises by an experienced official. Furthermore, the loans were never monitored, and actions were not taken to realize them even when the banks came to know that they had become default.

• The former BB governor said political influence works in two ways: when taking loans and preventing banks from taking actions, when the loans turn bad.

• Poor governance at bank boards, inadequate credit information, and inadequate financial statements of borrowers are major factors contributing to poor asset quality, according to an International Monetary Fund report on Bangladesh in January 2016.

• The banking reforms committee of the mid-1990s had identified state banks as the most problematic area and nothing has changed in the two decades. Once a high performer, BASIC Bank has been reduced to a bad bank after appointment of corrupt people on its board.

• Since assuming office in 2009, the then government in many cases appointed board members on political considerations, even though the last national banking advisory committee formed by the government recommended that a panel of qualified people should pick directors.

• There was a lack of monitoring and supervising of the banking system on the BB's part, and no follow-up actions were taken at the right time.

• The WB called for improving the legal and financial framework for loan recovery.

• To ensure sustainable and prudent credit operations, more innovative approaches, along with judicial use of rescheduling and write-off, are needed to end the default culture. The willful defaulters must be held accountable, not rewarded through rescheduling.

• They (entrepreneurs) also mentioned that corruption, inadequate infrastructure, inefficient government bureaucracy, government instability and limited access to financing are the major impediments towards private investment.

The above few lines rightly captured the social reality and the researchers believe that a pragmatic approach should be immediately undertaken considering the issue as the most priority one. Bangladesh Bank as the regulator and guardian of the banking sector in the country should come up with feasible solutions to ensure sound health of the sector, which is not difficult; it requires strong level of commitment and change of traditional mindset.
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